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In the Supreme Court of the United States

OCTOBER TERM, 1975

No.

UNITED STATES OF AMERICA, PETITIONER

v.

CITIES SERVICE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The three successive opinions of the district court (Appendix A, *infra*, pp. 1a-60a) are reported at 316 F. Supp. 61, 330 F. Supp. 421, and 362 F. Supp. 830. The opinion of the court of appeals (Appendix B, *infra*, pp. 61a-92a) has not yet been reported.

JURISDICTION

The judgment of the court of appeals (Appendix C, *infra*, pp. 93a-94a) was entered on December 13, 1974. The court of appeals denied a petition for rehearing, with suggestion of rehearing *en banc* (Appendix D, *infra*, pp. 95a-96a) on February 4, 1975. By orders dated April 28 and May 27, 1975, Mr. Justice Marshall extended the time for filing a petition for a writ of certiorari to and including July 3, 1975. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether respondent's issuance of debentures in exchange for its outstanding preferred shares, pursuant to an order of the Securities and Exchange Commission which found the debentures to be the equitable equivalent of the preferred shares, gave rise to income tax deductions for amortizable bond discount.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Section 11(e) of the Public Utility Holding Company Act of 1935, 49 Stat. 822, 15 U.S.C. 79k(e), of Section 23(b) of the Internal Revenue Code of 1939, of Sections 163 and 1232 of the Internal Revenue Code of 1954, of Treasury Regulations 111 (1939 Code), Section 29.22 (a)-17 and of Treasury Regulations on Income Tax

(1954 Code), Section 1.61-12, are set forth in Appendix E, *infra*, pp. 97a-102a.

STATEMENT

In 1941, respondent was a registered public utility holding company under the Public Utility Holding Company Act of 1935, 49 Stat. 803, 15 U.S.C. 79 *et seq.* Pursuant to Section 11(b) of that Act, the Securities and Exchange Commission ordered respondent to simplify its corporate and capital structures. See *In the Matter of Cities Service Company, et al.*, 15 S.E.C. 962, 17 S.E.C. 5. In April, 1947, the Commission approved respondent's plan to accomplish these objectives (*In the Matter of Cities Service Company*, 25 S.E.C. 575), and the United States District Court for the District of Delaware enforced the plan. *In re Cities Service Company*, 71 F. Supp. 1003 (Appendix B, *infra*, pp. 64a-65a).

Prior to the execution of the plan of corporate simplification, respondent's capital structure was as follows: As of October 31, 1946, respondent owned the stock of a number of operating utility companies. It had outstanding five issues of long-term debt aggregating $100,488,300 in face amount. In addition to an issue of 3,702,000 shares of $10 par common stock respondent also had outstanding three issues of cumulative preferred and preference (hereinafter "preferred") no-par stock with a total stated value of $58,690,000 (25 S.E.C. at 578).

As of December 31, 1946, there were accrued and unpaid dividends of $49,671,950 on the preferred

stock, which was subject to call and redemption at stated value plus accrued and unpaid dividends and stated call premiums. Although respondent had not paid dividends on its cumulative preferred stock since 1932,[1] it nevertheless had had large earnings during this period. However, respondent's management had made large open market purchase of outstanding long-term debt and preferred stock while postponing the payment of dividends to the preferred shareholders. As of the end of 1946, respondent had a capital surplus of $22,580,396, and an earned surplus of $39,251,146, over and above the amount of accrued and unpaid dividends on its preferred stock and its capitalization. 25 S.E.C. at 578, 598-599. (Appendix A, *infra*, pp. 4a-5a; Appendix B, *infra*, pp. 65a-66a.)

The plan the Commission approved called for the retirement of respondent's long-term debt, in part from cash on hand and in part from the proceeds of the sale of stock of utility companies of which respondent was to be divested. It called also for the elimination of the preferred stock and for the issuance of $115,246,950 face amount of 3 percent sinking fund debentures, due in 1977, in exchange for all of the outstanding preferred stock and in discharge of all claims to unpaid dividends. 25 S.E.C. at 579-580. The face amount of the debentures

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[1] The only exception during the period 1932-1946 was a partial dividend payment in 1941 of $3 per share to the preferred shareholders (see 25 S.E.C. at 596, 598).

equalled the aggregate stated value, accrued and unpaid dividends, and call premiums of the preferred shares for which they were to be exchanged (Appendix A, *infra*, pp. 6a-8a; Appendix B, *infra*, pp. 65a-66a).

Under Section 11(e) of the Public Utility Holding Company Act, 15 U.S.C. 79k(e) (Appendix E, *infra*, pp. 97a-98a), the Commission could approve the plan of simplification of respondent's capital structure only if it found the plan to be "fair and equitable to the persons affected by such plan." The Commission recognized that "fairness requires that affected security holders receive, under the Plan, the equitable equivalent of what they surrender * * *" (25 S.E.C. at 597). Because of the claims of the preferred shareholders, the financial condition of the company, and the fact that respondent had failed to pay dividends to its preferred shareholders since 1932 despite substantial earnings, the Commission found the amended plan to be "fair and equitable," and further found that the debentures were the equitable equivalent of the preferred shares for which they were to be exchanged (25 S.E.C. at 597-602).

The amended plan was put into effect in May, 1947, and respondent's preferred shareholders received in exchange for their preferred shares debentures in face amount ($115,246,950) equal to the aggregate stated value ($58,690,000), accrued and unpaid dividends ($49,671,950), and call premiums of their shares ($6,885,000) (Appendix A, *infra*, pp. 6a, 7a-8a; Appendix B, *infra*, pp. 65a-66a).

After audit of respondent's taxable years 1953 and 1954, the Commissioner of Internal Revenue assessed additional income taxes which respondent paid. Within two years from the dates of payment, respondent filed claims for refund for those years, in which it claimed, for the first time, that its debentures issued in 1947 had been issued at a discount, so that, when it retired substantial amounts of its outstanding debentures in 1953 and 1954, in accordance with the sinking fund provisions, it was entitled to deductions for unamortized bond discount.[2] After the claim for 1953 was not acted upon for more than six months, and the claim for 1954 was denied insofar as it related to bond discount, respondent instituted this income tax refund suit in the United States District Court for the Southern District of New York (Appendix A, *infra*, pp. 29a-31a; Appendix B, *infra*, pp. 66a-67a).

The district court denied motions by both parties for summary judgment. It held that respondent's debentures had been issued at a discount insofar as the face amount of the debentures exceeded the greater of: (a) the amount received by respondent upon issuance of its preferred shares, found to be $45,-

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[2] Respondent's claims for refund for 1953 and 1954 were $139,201.10 and $200,085.69, respectively. Respondent also filed, more than two years after payment of the deficiency for 1954, an increased claim for refund of $468,129.65, which it termed an amended claim. That claim asserted additional facts and different grounds of recovery, *i.e.*, that respondent sustained a deductible loss (Pltf. Exs. Nos. 2-A, 2-B).

323,846, or (b) the value to respondent of the preferred shares received in exchange for its debentures. The district court found that the amount of the purported discount was the sole factual question to be resolved, and set this question for trial (Appendix A, *infra*, pp. 26a-29a, 31a-32a). It thereafter denied the government's second motion for summary judgment after the intervening decision of the Court of Claims on rehearing in *Missouri Pacific Railroad Co.* v. *United States*, 433 F.2d 1324 (Appendix A, *infra*, pp. 33a-38a).

After trial, the district court found that the value of respondent's preferred shares, eliminating enhancement due to the fact that they were to be exchanged for the debentures, was $86,313,600. It concluded that respondent had deductible amortizable bond discount equal to the difference between the face amount of the debentures ($115,246,950) and the fair market value of the preferred stock ($86,313,600) (Appendix A, *infra*, pp. 39a-58a).

Both parties appealed. The court of appeals deferred consideration of the case pending this Court's decision in *Commissioner* v. *National Alfalfa Dehydrating*, 417 U.S. 134. A divided court of appeals then affirmed the district court's conclusion that respondent's debentures had been issued at a discount.

The court rejected the government's contention that *National Alfalfa* controlled and established that respondent's debentures were not issued at a discount. The court further held that the measure of the discount was the difference between the face amount of

the debentures and the debentures' market value at issuance. It noted that the closing market price of the preferred on the day prior to the exchange was $104,827,450 and the closing market price of the debentures on the date of issuance was $105,883,135, and stated that "both of these figures may be relevant to the determination of the market value of the debentures at the time of their issuance" (Appendix B, *infra*, p. 84a). The court of appeals remanded the case to the district court for a determination of the market value of the debentures at the time of their issuance (Appendix B, *infra*, pp. 62a-91a).

The dissenting judge would have dismissed respondent's complaint. He characterized the majority's analysis as "counter to the essential thrust of *National Alfalfa*, particularly part IV thereof, considered in the light of the Public Utility Holding Company Act of 1935 * * *." Since "[t]here was here in the restructuring of [respondent] no raising of new capital but merely reshuffling of the old," the dissenting judge concluded that the issuance of the debentures in exchange for preferred stock did not give rise to amortizable bond discount (Appendix B, *infra*, pp. 91a-92a).

REASONS FOR GRANTING THE WRIT

1. The decision of the court of appeals that respondent's issuance of debentures in exchange for its outstanding preferred shares gave rise to income tax deductions for amortizable bond discount conflicts with this Court's decision in *Commissioner* v. *Na-*

tional Alfalfa Dehydrating, 417 U.S. 134. The court below has misapprehended the rationale of that case and has thereby recreated the conflict which previously had been put to rest by *National Alfalfa*. Moreover, the decision below conflicts with that of the Court of Claims in *Missouri Pacific Railroad Co.* v. *United States*, 433 F.2d 1324, certiorari denied, 402 U.S. 944, and of the Fifth Circuit in *Claussen's, Inc.* v. *United States*, 469 F.2d 340.

The continuing uncertainty and judicial conflict surrounding the tax consequences of the issuance of billions of dollars of debentures by railroads and public utilities in reorganizations requires resolution by this Court.

2. The decision of the court of appeals conflicts with *Commissioner* v. *National Alfalfa Dehydrating*, *supra*. There, the Court held that a recapitalization through the issuance of a $50 face amount debenture in exchange for each share of outstanding $50 par cumulative preferred stock did not give rise to a deduction for amortizable bond discount. In so holding, the Court reversed the decision of the Tenth Circuit which had upheld the taxpayer's claim to discount equal to the difference between the face amount of the debentures and the market value of the preferred shares at the time of the exchange.

In *National Alfalfa*, the Court reaffirmed its earlier statements that debt discount is "an additional cost incurred in borrowing money" which " 'serves the same function as stated interest' " (417 U.S. at 145). As the Court observed by reference to a proto-

type example (*id.* at 143), original-issue discount arises where a corporate issuer sells its 6 percent ten-year debt obligation for $950 in cash where the face amount of the note is $1,000. The $50 difference between the face amount of the obligation and the issue price is an additional cost to the issuing corporation for the use of the money it is borrowing. Accepted tax accounting permits the $50 discount to be ratably deducted as additional interest over the life of the bond, *i.e.*, $5 per year.

Viewed in the context of the prototype example, the taxpayer in *National Alfalfa* incurred no discount as a result of its recapitalization. As the Court explained, "[f]rom the perspective of the corporation, the transaction was the exchange of one form of interest or participation in the corporation for another. But the corporate assets were neither increased nor diminished" (*id.* at 151-152). In the Court's view, "the interest of the preferred shareholders 'was fairly reflected in the highly equivalent characteristics of the debentures into which the preferred was converted' " (*id.* at 154). Since the debentures were the equivalent of the preferred stock for which they were exchanged, the issuance of the debentures did not involve borrowing and therefore did not give rise to any discount. The market value of the preferred shares at the time of the exchange was irrelevant.

As in *National Alfalfa*, the transaction in this case involved an exchange of equivalents. Indeed, the Public Utility Holding Company Act requires that

conclusion and makes this Court's analysis in *National Alfalfa* fully applicable to respondent's issuance of debentures in exchange for its outstanding preferred stock. Pursuant to Section 11(e) of that Act, the Securities and Exchange Commission could approve respondent's capital simplification plan only if it found that the plan was "fair and equitable to the persons affected by [it]." In making that determination, the Commission was required to apply the principle of full priority to the interest of the preferred shareholders by considering respondent's entire financial structure as well as the corporate charter provisions in order to see that the preferred shareholders received the equitable equivalent of the securities surrendered. *Otis & Co.* v. *Securities and Exchange Commission*, 323 U.S. 624; *Securities and Exchange Commission* v. *Central-Illinois Corp.*, 338 U.S. 96, 144-145. However, the Public Utility Holding Company Act does not require the Commission to be guided by the market value of the securities. As this Court stated in *Niagara Hudson Corp.* v. *Leventritt*, 340 U.S. 336, 346-347, "[t]he informed judgment of the Commission, rather than that of the market, has been designated by the Act as the appropriate guide to fairness and equity within the meaning of the Act."

The Commission properly determined that debentures in the aggregate face amount of $115,246,950 were the equitable equivalent of the preferred shareholder's claim. This figure was comprised of the stated value of the preferred shares ($58,690,000), the accrued and unpaid dividends ($49,671,950), and

the call premiums ($6,885,000) on those shares. Such a determination of equitable equivalence by the Commission under Section 11(e) of the Public Utility Holding Company Act is conclusive if it is supported by substantial evidence. *Securities and Exchange Commission* v. *Central-Illinois Corp.*, *supra*, 338 U.S. at 125-127; *Niagara Hudson Corp.* v. *Leventritt*, *supra*, 340 U.S. at 340, n. 4. Here, the evidence supporting the Commission's finding of equitable equivalence was compelling and the district court upheld that finding (71 F. Supp. at 1004). Because respondent was fully solvent, its certificate of incorporation would have required it to expend $115,246,950 in cash if it wanted to retire the preferred shares. The Commission was fully justified in taking that fact into account. See *Securities and Exchange Commission* v. *Central-Illinois Corp.*, *supra*, 338 U.S. at 144-145.

Since the debentures issued by respondent were the equitable equivalent of the preferred shares, it follows here, as it did in *National Alfalfa*, that the debentures simply replaced the preferred stock interest and gave rise to no additional cost of borrowing. The conclusion of the court of appeals that a portion of the face amount of the debentures constituted discount necessarily disregards the Commission's finding of equitable equivalence, as well as this Court's decisions holding that such a Commission finding is conclusive if supported by substantial evidence. The Commission's 1947 determination of equitable equivalence, upheld by the district court at that

time, is not subject to collateral review by the courts below more than 25 years later.

The court of appeals simply ignored the Commission's finding of equitable equivalence. Instead it attempted to distinguish this Court's *National Alfalfa* decision as follows (Appendix B, *infra*, pp. 77a-78a):

> The critical fact that distinguishes that case [*National Alfalfa*] from the instant one is that all that occurred there was the substitution of one fixed $50 obligation for another.
>
> * * * * *
>
> In the instant case, there is no such equality. The face amount of Cities' debentures far exceeds both the stated value of the preferred and the original consideration paid in at the time of its issuance.

The proper comparison, however, is not between the face amount of the debentures and "the stated value of the preferred and the original consideration paid in at the time of its issuance," but between the face amount of the debentures and the total claim of the preferred stockholders against the corporation at the time of the exchange. As noted above (pp. 4-5), under the amended plan the preferred stockholders received debentures whose total face amount equalled the aggregate stated value, the accrued and unpaid dividends and the call premiums of the preferred shares. That was the total claim of the preferred against the company, and that was the total amount the preferred stockholders received in satisfaction of their claim when they received debentures in ex-

change for the stock. The present case, therefore, involves the identical situation that existed in *National Alfalfa* as the court of appeals viewed that case: "[T]he substitution of one fixed * * * obligation for another" of the same amount.

The holding of the court of appeals that respondent incurred discount because the face amount of the debentures exceeded the stated value of its eliminated preferred shares conflicts with *Claussen's, Inc.* v. *United States*, 469 F.2d 340 (C.A. 5), which this Court cited with approval in *Commissioner* v. *National Alfalfa Dehydrating, supra*, 417 U.S. at 153 and n. 13. There, the Fifth Circuit rejected a claim that discount arose when a corporation issued debentures in face amount greater than the par value of the stock for which they were exchanged. The court pointed out, in terms equally appropriate here, that the corporation had acquired no new capital and that the shareholders had surrendered nothing to the corporation for which there could be a cost of borrowing (see 469 F.2d at 344, n. 11). On this basis, respondent's claimed bond discount deduction must likewise fail.

3. The decision below also conflicts with *Missouri Pacific Railroad Co.* v. *United States*, 433 F.2d 1324 (Ct. Cl.), certiorari denied, 402 U.S. 944. In that case, the Court of Claims held, with respect to an essentially identical transaction, that where the Interstate Commerce Commission determined in a railroad reorganization case that stock was the "equitable equivalent" of bonds, this finding was conclu-

sive that no discount arose upon the issuance of the bonds. As that court stated, "[t]here was, therefore, no debt discount on the issuance of the bonds since the plaintiff-taxpayer received at least the equivalent (in stock value) of the maturity value of the bonds" (433 F.2d at 1326).[3]

The fact that *Missouri Pacific* involved a determination by the Interstate Commerce Commission that a reorganization plan was "fair and equitable" under Section 77 of the Bankruptcy Act, as amended, 11 U.S.C. 205, while this case involved a determination by the Securities and Exchange Commission that a capital simplification plan was "fair and equitable" under Section 11(e) of the Public Utility Holding Company Act is not a meaningful distinction. In *Otis & Co.* v. *Securities and Exchange Commission*, *supra*, 323 U.S. at 634, and *Securities and Exchange Commission* v. *Central-Illinois Corp.*, *supra*, 338 U.S. at 119-126, this Court pointed out that the Public Utility Holding Company Act and the bankruptcy and reorganization statutes both make applicable a "fair and equitable" standard that incorporates the prin-

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[3] While the Court of Claims endorsed the analysis of the original opinion of the district court in this case (316 F. Supp. 61), there is nevertheless a conflict between its disposition and the decision below because both cases involve determinations of equivalence by administrative agencies which are conclusive. Although the Court of Claims adhered to the finding of the Interstate Commerce Commission, the court here ignored a similar determination by the Securities and Exchange Commission.

ciple of full priority in the treatment to be accorded various clauses of security interests.

4. The court of appeals' error is further shown by its conclusion that the measure of the discount was the difference between the face amount of the debentures and their market value at the time of issuance. If a corporation issues a $100 face amount debenture for $100 in cash, it incurs no discount upon issuance. This is true even though the original purchaser of the debenture may have misjudged the market so that he can sell the debenture for no more than $98. The $98 market value demonstrates neither the existence nor the measure of discount, since the issuer has the full $100 at its disposal.

Here, too, the Commission determined that respondent's preferred shareholders gave up a claim equivalent to the face amount of the debentures. Thus, the fact that respondent's debentures may have immediately sold for less on the open market neither indicates nor measures discount to respondent as the issuer of the debentures.

The error of the court of appeals apparently stemmed from its misreading of Part III of this Court's *National Alfalfa* opinion, 417 U.S. at 147-151. There, in holding that the taxpayer did not incur discount equal to the difference between the face amount of its debentures and the market value of the preferred stock for which it was exchanged, the Court noted that there was "no evidence of what the fair market value of the bonds was at the time of their issuance" (417 U.S. at 151).

Although the court of appeals quoted this statement in support of its holding with respect to the measure of discount (Appendix B, *infra*, p. 81a), this Court made this observation in *National Alfalfa* in the context of rejecting the taxpayer's attempt to reconstruct the transaction by analogy to the issuance of the $50 bonds for $33 in cash and the use of the cash to retire the stock. Both here and in *National Alfalfa*, the taxpayer did not issue its bonds for cash and the Court held in *National Alfalfa* such an analysis would "require rejection of the established tax principle that a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred" (417 U.S. at 148). But the Court further noted that even assuming *arguendo* the correctness of the taxpayer's reconstruction argument, it would require speculation about the amount that the debentures would yield to the taxpayer if they had been issued for cash.

Thus, the Court's statement concerning the lack of market value evidence was simply directed at reinforcing the soundness of the rule foreclosing hypothetical reconstruction of transactions.[4] It did not mean that discount arises upon such an exchange of equivalents simply because the debentures may have an ascertainable lower market price. That price does not reflect the amount of the corporation's borrow-

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[4] As the Court noted (417 U.S. at 151), the Tax Court had made the same observation in the course of rejecting the taxpayer's hypothetical reconstruction of the transaction. See 57 T.C. at 52, n. 6.

ing and therefore cannot serve as a reliable measure of discount.

5. In our petition for a writ of certiorari in *Commissioner* v. *National Alfalfa Dehydrating* (No. 73-9), we stated that the question whether bond discount arises upon the exchange of bonds for the outstanding shares of the issuer was of great administrative importance. The significance of the question has not diminished in the past two years. We are informed by the Internal Revenue Service that there are still outstanding billions of dollars of long-term bonds that were issued in substitution or exchange for other securities in railroad reorganizations alone. In addition, as this case demonstrates, there are similar bond issues outstanding, in amounts difficult to estimate, presenting the same question in connection with the reorganization of public utility holding companies.

Claims for discount will be potential and recurring during the many years that these bonds will remain outstanding. Though we believed that the Court's *National Alfalfa* opinion had definitively spoken with respect to these issues, it is apparent that the decision below has renewed, and perhaps exacerbated, the previously existing conflicts. These require resolution by this Court.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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JULY 1975.

APPENDIX A

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

67 Civ. 4606

[Filed Jul. 24, 1970, 11:00 a.m., U. S. District Court, S. D. of N. Y.]

CITIES SERVICE COMPANY, PLAINTIFF

—against—

UNITED STATES OF AMERICA, DEFENDANT

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MANSFIELD, D.J.

In this action brought pursuant to 26 U.S.C. § 7422 and 28 U.S.C. § 1346(a) for the refund of taxes paid during the taxable years 1953 and 1954, defendant United States has moved for summary judgment. Plaintiff counters that there are fundamental unresolved issues of fact requiring denial of the motion, and argues in the alternative that if summary judgment is to be granted, it must be granted in plaintiff's favor. For reasons discussed in detail below, we deny both motions but conclude pursuant to Rule 56(c) and (d) that no genuine issues exist as to plaintiff's claim except as indicated.

The action arises out of plaintiff's issuance in 1947 of $115,246,950 in 3% thirty-year sinking fund debentures in exchange for its then outstanding preferred and preference stock. Plaintiff contends that the debentures were issued for a consideration amounting to less than their face value. More specifically it claims that its preferred and preference shares received in exchange were worth substantially less than the face amount of the debentures.

In 1953 and 1954 plaintiff repurchased certain of the debentures. It contends that these purchases resulted in losses to it which were deductible pursuant

to § 165(a) of the Internal Revenue Code.[1] Furthermore, on the theory that the debentures were issued at a discount in 1947 it claims the right to deduct annually an amortized percentage of the discount over the life of the debentures pursuant to Internal Revenue Regulation § 1.61-1 the relevant portion of which provides:

> ". . . If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. . . ."[2]

Defendant contends that the consideration received by plaintiff upon issuance of the debentures was exactly equal to their face amount, and that since defendant received "equal for equal" no loss was sustained. Furthermore, defendant argues that even if there was a differential between the face amount of the debentures and the consideration received, it

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[1] *"General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."

[2] Regulation § 1.61-12 is, in all pertinent respects, substantially identical to its predecessor under the 1939 Code.

would not amount to a deductible "discount" within the meaning of the above-quoted regulation.

Background

In late January, 1941, plaintiff Cities Service became a registered holding company under the Public Utility Holding Company Act of 1935, thereby subjecting itself to special regulation by the Securities and Exchange Commission. Pursuant to that Act and to various orders issued by the SEC, Cities Service was required to divest itself of certain of its public utility interests and to undertake a simplification of its corporate and capital structures.

Accordingly, on November 20, 1946, Cities Service presented a "Plan pursuant to Section 11(e) of Public Utility Holding Company Act of 1935 for simplification of corporate structure" to its shareholders and to the SEC. At the time of the submission of this original plan Cities Service had outstanding, in addition to slightly over 100 million dollars in debentures and about 37 million dollars par value of common stock, three classes of no par voting cumulative preferred and preference stock whose stated value aggregated about 58.7 million dollars. The dividends on these three classes of preferred stock had been passed for 14 years, and the arrearages totalled approximately 49.7 million dollars. The plan submitted provided for prompt cash redemption of the outstanding debentures, and for the exchange of the preferred and preference stocks for an issue of 3% fifty-year sinking fund debentures in an amount

equal to the stated value of the preferred and preference shares plus accumulated and unpaid dividends, or approximately 108.4 million dollars. The plan further provided that approval of the exchange by the holders of 60% of the preferred shares would be required before the plan would become effective.

Beginning in December, 1946, and continuing for some months thereafter, the SEC conducted hearings on the fairness of the plan. On the opening day of the hearings objections to the plan were raised by various preferred shareholders. They pointed out that while debenture holders, upon retirement of their securities, were being given their full call price in cash, the preferreds were to receive only the liquidation value of their shares, and even that in the form of securities which could not be expected to sell at par under prevailing market conditions. Cities Service's earnings, they argued, had long been and would continue to be sufficient to pay dividends on the preferred if the management would only forego its established policy of using all surplus earnings to retire debt. Under the circumstances, they contended, Cities Service should pay the full call price of the preferred shares as well as that of the outstanding debentures to be retired. It was also suggested that the interest rate on the debentures to be issued in exchange for the preferred stock be raised to 3½%, presumably to increase the chances that the debentures could be sold at par.

On February 14, 1947, after extensive testimony by Cities Service executives, engineers and invest-

ment bankers as to the fairness of the proposed plan, and shortly before a preferred shareholders' committee was to proceed with its opposing proof, Cities Service amended its plan to meet the objections of the preferred shareholders. The amended plan reduced the maturity of the 3% debentures from fifty to thirty years, awarded the preferred stockholders debentures in a principal amount equal to the call premium on their shares plus their stated value and dividend arrearages, dispensed with the necessity of stockholder approval of the exchange, and restricted the rights of Cities Service to declare common stock dividends and to incur new debt during the life of the debenture issue.

The preferred shareholders thereupon withdrew their objections to the amended plan. On April 24, 1947, the amended plan was approved by the SEC. Three days later the United States District Court for the District of Delaware signed an order enforcing the plan, which thus became effective on May 27, 1947.

At the time the plan became effective, Cities Service had outstanding three separate classes of preferred and preference stock: (1) preferred stock, (2) preference B stock, and (3) preference BB stock.

The preferred class consisted of 560,600 shares of $6.00 cumulative preferred stock carrying an annual dividend of $6.00 and callable at plaintiff's option at any time at a price of $112.00 per share ($100.00 stated value plus $12.00 call premium) plus accumu-

lated and unpaid dividends. As of May 27, 1947, each share of preferred was carrying $84.50 in accumulated and unpaid dividends. The redemption price for each share of preferred was thus $196.50 and the total redemption price for the 560,600 shares outstanding was $110,157,900.

The preference B class consisted of 86,000 shares of 60¢ cumulative no par stock carrying an annual dividend of 60¢ and callable at plaintiff's option at a price of $10.60 ($10.00 stated value plus 60¢ call premium) plus accumulated and unpaid dividends. As of May 27, 1947, each share of preference B stock was carrying $8.75 in accumulated but unpaid dividends. The redemption price for each share of preference B was thus $19.35 and the total redemption price for the 86,000 shares outstanding was $1,664,100.

The preference BB class consisted of 17,700 shares of $6.00 cumulative no par shares carrying an annual dividend of $6.00 and callable at plaintiff's option at a price of $106.00 ($100.00 stated value plus $6.00 call premium) plus accumulated and unpaid dividends. As of May 27, 1947, each share of preference BB stock was carrying $87.50 in accumulated and unpaid dividends. The redemption price for each share of preference BB was thus $193.50 and the total redemption price for the 17,700 shares outstanding was $3,424,950.

On May 28, 1947, plaintiff issued its thirty-year 3% sinking fund debentures in the aggregate amount

of $115,246,950 in exchange for all its outstanding preferred, preference B and preference BB shares, all rights appertaining thereto, and all dividend arrearages thereon. Each share of each class thus received precisely its call price in face amount of the new debentures in the exchange. By the terms of the indenture plaintiff was required to retire at least $1,500,000 in principal amount of debentures annually. Accordingly, during the taxable year 1953 it repurchased $1,519,500.00 face amount of debentures at an aggregate cost of $1,398,357.39, and during the taxable year 1954 purchased $1,805,900.00 face amount of debentures at an aggregate cost of $1,786,569.02.

Two other figures whose relevance will become apparent further on in this discussion are worthy of mention. Plaintiff Cities Service contends, and for purposes of this motion the United States is willing to concede, that the three classes of preferred and preference shares under discussion were originally issued by the plaintiff at various times in consideration for cash and properties having an aggregate fair market value at the time of issuance of no more than $45,323,846.00. Similarly the plaintiff contends, and defendant provisionally concedes for purposes of its motion, that at the time of the exchange in 1947 the aggregate fair market value of the preferred and preference shares was $86,313,600.00.

Plaintiff's Theories of Recovery

Plaintiff advances two theories in support of its claim to a tax deduction arising from its repurchase of debentures in 1953 and 1954. Both theories are based on plaintiff's contention that it paid more to redeem the debentures than it received in exchange for them upon issuance in 1947. What it received—the issue price of the debentures—plaintiff contends, was either the fair market value of the preferred and preference shares surrendered upon the 1947 exchange ($86,313,600.00), *or* the fair market value of the cash and properties originally paid in upon issuance of those shares in prior years ($45,323,-846.00). The first theory holds simply that a deductible loss was realized upon repurchase of debentures at a price higher than the price realized upon their issuance. The second theory, based on Reg. § 1.61-12, holds that the issuance of the debentures at less than face in 1947 gave rise to bond "discount" within the meaning of that Regulation, entitling plaintiff to prorate or amortize the discount over the life of the bonds and to deduct both the amortization thereof for the taxable years in question and the unamortized portion of the discount attributable to the debentures retired in those years. Each theory produces two figures for the proposed deduction, depending on which of the two measures of the issue price of the debentures in 1947 is employed. See Complaint ¶¶ 35-39, 44-48.

Defendant's answer to both theories is the same: the debentures were in fact issued at face value.

Hence no discount arose from the exchange, and since the consideration received for the debentures equalled their face value, no loss was sustained when plaintiff repurchased them at less than face in 1953 and 1954. Defendant also contends that even if the debentures were issued at less than face, the differential is not deductible discount.

Discussion

Three distinct questions are presented on this motion. *First*: Was the consideration received by Cities Service in exchange for the debentures issued in 1947 less than the face or principal amount of the debentures? *Second*: If so, does the difference give rise to a deductible loss or, in the alternative, to an amortizable discount within the purview of Reg. § 1.61-12? *Third*: How is the difference, if any, to be measured?

Was the Consideration Received Less than the Face Amount of the Debentures?

At the outset we are confronted with the fact that the face amount of the debentures issued in 1947—$115,246,950—was identical with the cash amount that plaintiff would have been required to pay to the preference and preferred shareholders if it had chosen to redeem their shares. If it had redeemed the shares, the aggregate amounts paid out in cash would have been as follows:

Stated value	$ 58,690,000
Accrued undeclared cumulative dividends	49,671,950
Redemption premium	6,885,000
Redemption call price	$115,246,950

Seizing upon this identity of figures defendant contends that what really happened during the course of the hearings before the SEC was that plaintiff redeemed the preferred and preference shares, paying the full call price for them, albeit in the form of debentures rather than cash. According to defendant the issuance of the debentures and plaintiff's receipt of stock constituted the cancellation of concrete obligations totalling $115,246,950, and plaintiff's only real alternative would have been to issue debentures on the market and then redeem the preferred and preference shares by paying the full call price in cash to their holders. Instead plaintiff chose, in defendant's view, to pay off the shareholders in debt paper.

There are fatal flaws in defendant's position. In the first place, debentures are frequently not worth their face value in cash, particularly where the interest yield (here only 3%) compares unfavorably with the current market, in which event they can only be issued for a consideration less than their face value. Indeed plaintiff has offered abundant proof that here the actual value of the shares received in exchange for the debentures was substantially less than the redemption call price, and defendant has offered no contrary proof. For instance, the

aggregate closing market price of the shares on the day before the exchange was $104,827,450. An expert appraisal of the shares, adjusted to eliminate the effects of the impending exchange, concludes that their inherent fair market value on May 27, 1947, was $86,313,600. Moreover, plaintiff, upon original issuance of the shares, received an aggregate of only $45,323,846 as against the much higher redemption call price. Lastly, between the time when the amended plan was proposed (after which investors could and would value the Cities Service preferred and preference stocks with reference to the securities for which they were soon to be exchanged) and the date of the exchange, plaintiff's preferred shares never sold at more than 91% of the face amount of the debentures they represented. On the date of their issue, furthermore, the debentures closed at 91⅞, their high for the day, and did not get above 93 for over two months. Thus all proof before us indicates that the shares were worth less than the face amount of the debentures issued.

Secondly, it is clear that the 1947 exchange did not constitute a redemption. Under the terms of plaintiff's charter a redemption would occur only if plaintiff voluntarily and unilaterally retired its shares by payment of the agreed-upon redemption call price in cash to the shareholders, in which event the latter had no alternative but to accept the cash redemption call price. (Def's Ex. D, Section Fourth, ¶ 7). No cash was paid. Instead, plaintiff, with the SEC's approval, exchanged debentures which accord-

ing to their terms would not be redeemable in cash for thirty years. The preferred and preference shareholders' rights upon liquidation did not mature by reason of the operation of Section 11 of the Public Utility Holding Act.[3] Furthermore, it was not necessary for the provisions of the charter to be followed in a plan of simplification pursuant to Section 11 of the Public Utility Holding Company Act. *In re Electric Bond & Share Co.*, 73 F. Supp. 426, 446 (S.D. N.Y. 1946). The SEC had the power to authorize plaintiff, in its simplification of its financial structure pursuant to the SEC's order, to adopt a plan for retirement of the preferred and preference shares which would not amount to a redemption. *In re Electric Bond & Share Co., supra.* For instance, the SEC could even have authorized plaintiff to make a cash purchase of the outstanding shares in the open market at less than the redemption call price.[4]

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[3] *In re New England Public Service Co.*, 73 F. Supp. 452, 456 (D. Me. 1947); *In re United Light & Power Co.*, 22 S.E.C. 704, 715-17 (1946).

[4] SEC Reg. § 250.42 (CCH Fed. Sec. L. Rep., Vol. 3, ¶ 37,522), adopted in Release No. 35-6, Oct. 9, 1935, and amended in Release No. 35-6318, Dec. 27, 1945 (10 F.R. 15412), provides that

> "No registered holding company or subsidiary thereof shall acquire, retire or redeem any security of which it is the issuer (or which it has assumed or guaranteed) except pursuant to a declaration notifying the Commission of the proposed transaction, which has become effective in accordance with the procedure specified in § 250.23 [¶ 36,655], and pursuant to the order of the

In fact the amended plan did not conform to the specific redemption provision of plaintiff's charter. As the SEC observed in its Findings and Opinion on the plan, retirement of securities pursuant to a plan of simplification under Section 11 of the Public Utility Holding Company Act is not voluntary. Furthermore the shareholders were not required at plaintiff's option to accept the plan, as would have been the case if their shares had been redeemed for cash pursuant to the charter. Since plaintiff offered debentures rather than cash, the stockholders exercised their right to oppose the plan and in fact the plan was consummated only after hard bargaining and a modification of the original offer resulted in their withdrawing their initial objections.

This view of the transaction was confirmed by the SEC which, in its Findings and Opinion on the amended plan of simplification, concluded that Cities Service's financial structure made it "extremely unlikely that Cities could presently undertake to redeem or refinance its preferred stock." [5] Furthermore the SEC stated plainly that the equivalence of call price and face amount of the debentures issued

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Commission with respect to such declaration under the applicable provisions of the Act."

Certain exceptions and provisos follow, none of which are applicable to the transaction before us. The "procedure specified in § 250.23" is purely technical, and presents no obstacle to SEC approval of a cash deal with preferred shareholders.

[5] Def's Ex. G at p. 24.

should not be interpreted to mean that a redemption had taken place:

> "It is well established that in measuring the claims which preferred stockholders surrender in a Section 11(e) plan such as this, their rights in liquidation are not considered to have matured by operation of Section 11; and consideration must be given to all of the rights and limitations attaching to the preferred stocks, with primary emphasis upon immediately operative rights such as rights in respect of earnings and dividends as against inchoate rights such as rights in liquidation. [Citations omitted]" (Def's Ex. G at 22).

Finally, in a footnote to its observation that if the new debentures should be called in the future the then holders would at that time receive an amount equal to the redemption call price of the shares, the Commission stated:

> "This result does not mean that we consider that the claims of the preferred and preference stockholders are being retired at their respective call prices, nor that they are entitled as a matter of law to the call price as such. It is well established that a retirement of senior securities pursuant to the impact of Section 11 is not a voluntary retirement so as to bring into play the redemption provisions of the charter or indenture. [Citations omitted]" (Def's Ex. G at 25 n.35).

Nor did the SEC's determination that the plan was fair and equitable to all parties and that the debentures were the "equitable equivalent" of the rights

surrendered imply that the debentures were worth their face value at the time of issuance. It merely meant that their discounted value was approximately equal to the value of the properties received in exchange. This was later recognized by the district court in discussing the argument that under the amended plan the redemption premium was being paid:

> "The argument that the premium is being paid must be based on the assumption that these 3% debentures are the equivalent of money. This is an assumption which I refuse to make. Even conceding that the debentures are superior in quality to the old preferred stock, it is still not certain that they are of grade to sell on a money basis and even if they were, what the rate would have to be to support a price of 100." (*In re Cities Service Company*, 71 F. Supp. 1003, 1005 (D. Del. 1947))

Thus the district court anticipated Judge (now Justice) Marshall's later observation in *Nassau Lens Co.* v. *Commissioner*, 308 F.2d 39 (2d Cir. 1962), that "surely a promise today to pay $150,000 in ten years is not presently worth $150,000 either in property or cash." (308 F.2d at 44).

Admittedly the decision to issue debentures in an aggregate face amount equal to the redemption call price of the preferred shares presented a superficial identity that lends support to defendant's position. The history of the parties' negotiations and of the proceedings before the SEC, however, confirm that the

identity in face amounts represented nothing more than a plausible trading objective used by shareholders who objected to the original plan. Since holders of the existing 5% Convertible Debentures were under the plan to be paid the full call price of their bonds in cash, it was natural for the preferred shareholders to demand debentures equal to the call price of their shares. However, it was anticipated that the 3% debentures to be issued would probably be worth, in current market terms, significantly less than their face value. Apparently recognizing this the shareholders also sought an increased interest rate on the new debenture and more favorable terms in the indenture. See Def's Ex. E at 7-8, 12, 1144-45. The totality of these circumstances robs defendant's contention (that the exchange amounted to a redemption) of its force.

In further support of its contention defendant points to the fact that the plan as originally proposed contained a condition that 60% of the affected shareholders must approve the exchange before it could become effective, and that this condition was later deleted, thus making it possible to effectuate the change without shareholders' approval, just as a redemption could be carried out under the terms of the corporate charter. (Def's Main Brief at 6; Def's Ex. D Section "Fourth" Par. 7). The simple answer is that shareholder approval was not required for consumation of any exchange authorized by the SEC, including the exchange contemplated in the original plan. Furthermore, plaintiff's president in his testi-

mony before the SEC Hearing Examiner explained that the original provision requiring shareholder approval was motivated by management's feeling that it had an obligation not to try to push the plan through without shareholder backing. (Def's Ex. E at 51). Removal of the provision was largely a response to shareholders' objections to expenditures for solicitation of stockholders' assents. (See Def's Ex. E at 13, 1122-23, 1144).

In conclusion we view the 1947 issuance of debentures as an exchange and not a redemption.[6] It was a transaction whereby shareholders (whose dividends and preferential rights had long been "of little practical moment to them"[7]) became creditors owning long term debentures instead of stock. However one chooses to measure the consideration they gave up, there is every indication that it was substantially less than the face amount of the debentures they received.

Is the Difference Deductible?

If plaintiff had in 1947 issued its debentures for cash amounting to less than the face amount of the

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[6] Although the terms used in the amended plan would not be controlling, it is significant that the parties and the SEC described the issuance of debentures as an "*exchange,*" as distinguished from the retirement of the 5% Convertible Debentures, which was properly described as a "redemption," or call and cash payment in accordance with their terms. (Def's Ex. G, p. 7).

[7] Def's Ex. G at 23.

debenture, it would, upon redeeming some of the debentures, have been entitled to deduct the excess paid out over the cash received as a loss under § 165(a) of the 1954 Code and treat the entire difference as an amortizable discount under Reg. § 1.61-12(c). *Helvering* v. *Union Pacific R.R.*, 293 U.S. 282 (1934). Defendant further concedes that if plaintiff "had issued bonds at a discount and realized a net amount sufficient to purchase the securities in the market the difference between the face amount of the debentures and the realization would have been properly treated as discount" (Def's Memorandum at 31).

Similarly if plaintiff had issued the debentures in exchange for property worth less than the face amount of the debentures, it is settled in this Circuit that the difference could be treated in the same fashion. *Nassau Lens Co.* v. *Commissioner*, 308 F.2d 39 (2d Cir. 1962) (Marshall, C.J.); *American Smelting & Refining Co.* v. *United States*, 130 F.2d 883 (3d Cir. 1942). The difference between the face amount of the bonds issued for property and the market value of the property acquired is treated as discount for the reason that it represents the cost of the money that would otherwise have to be borrowed in order to make a cash purchase of the property received in exchange. *Nassau Lens Co.* v. *Commissioner, supra.*

Defendant argues strenuously that in addition to establishing that the property acquired is worth less than the face amount of bonds issued for it, the taxpayer cannot treat the difference as a discount unless it also sustains the burden of proving that the

difference is traceable to market demand for a higher effective interest rate than the stated yield of the bonds. While nothing in Reg. § 1.61-12(c) either requires or implies such a limitation, there is unquestionably judicial support for the proposition. See, e.g., *San Joaquin Light & Power Corp.* v. *McLaughlin*, 65 F.2d 677 (9th Cir. 1933); *Dodge Brothers* v. *United States*, 118 F.2d 95 (4th Cir. 1941); *American Smelting & Refining Co.* v. *United States*, 130 F.2d 883 (3d Cir. 1942); *Montana Power Co.* v. *United States*, 232 F.2d 541 (3d Cir. 1956) (dictum); *Atchison, Topeka & Santa Fe Ry.* v. *United States*, 69-2 U.S.T.C. ¶ 9740 (D.C. Kans. 1969) (semble). There is also support for the contrary proposition. See, e.g., *Baltimore Steam Packet Co.* v. *United States*, 180 F. Supp. 347 (Ct. Cl. 1960); *Roberts & Porter, Inc.* v. *Commissioner*, 307 F.2d 745 (7th Cir. 1962); *Universal Tractor-Equipment Corp.* v. *United States*, 67-1 U.S.T.C. ¶ 9409 (E.D. Va. 1967); *Missouri Pacific R.R.* v. *United States*, Nos. 142-67 & 95-68 (Ct. Cl. June 12, 1970). See also *Fashion Park, Inc.* v. *Commissioner*, 21 T.C. 600 (1954) (where, however, the Commissioner apparently conceded the point at issue here, and the discussion concerns income rather than loss deductions).

Without attempting a detailed analysis of the above-cited decisions or suggesting that a crystallized rule can be distilled from them as to precisely when a difference in consideration may or may not be treated as a discount, we are convinced that the conflict between the decisions is more apparent than real. The

general conclusion that we draw is that where a true loss has been sustained by the taxpayer's issuance of obligations payable at their face value at some future date, the debt-discount concept, which is at best a more or less arbitrary creation, will not be construed in a technical manner to bar the taxpayer from deducting the loss as discount. In short the difference between the face amount of a bond (which the issuer agrees to pay upon maturity) and the lesser consideration received upon its issuance "is normally considered" a discount in the absence of circumstances indicating that the difference was not intended as a discount. See *Erie Lackawanna R.R.* v. *United States*, 422 F.2d 425, 427-28 (Ct. Cl. 1970).

In this case we face an additional problem in that the property acquired by plaintiff in exchange for issuance of its debentures consisted of plaintiff's own preferred shares and the hope of the holders of such shares that the plaintiff might at some future time pay them the amount of the accrued but undeclared and unpaid cumulative dividends.[8] This raises the question of whether such a reduction or change in a taxpayer's own capital structure may be treated as giving rise to loss or discount. Where obligations are

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[8] A cumulative dividend provision merely bars the management from paying dividends on common stock until the accumulated dividends are paid to the preferred. It does not, however, constitute the preferred stockholder a creditor or claimant for the accumulated undeclared dividends, unless the dividends have been withheld in bad faith. 11 W. Fletcher, Cyclopedia of Corporations ¶ 5325; 12 *id.* ¶ 5451 and cases there cited.

issued for cash or other property in an amount less than face, the existence of a loss or discount is readily ascertainable by reference to the fair market value of the property acquired. Where a taxpayer, however, acquires at a discount (in exchange for new bonds or debentures) obligations for which it received consideration equal to the full face amount upon original issuance, it is in effect issuing a new discounted obligation in place of an old one. No loss has been suffered by the taxpayer because at one time it has received the full face amount of the originally issued obligation. For this reason a deduction of the difference between the fair market value of the outstanding obligations and the face amount of the new ones has sometimes been denied. *Missouri Pacific R.R.* v. *United States*, Nos. 142-67 & 95-68 (Ct. Cl. June 12, 1970); *Erie Lackawanna R.R.* v. *United States*, 422 F.2d 425 (Ct. Cl. 1970). Such a transaction is treated as an "exchange of equals" in which "The corporation has not obligated itself to pay out any more than it has received." *Missouri Pacific R.R.* v. *United States*, *supra*, Slip Op. at 5. Therefore the face value of the old obligations "at the time of their issuance is the true valuation of the securities *as far as plaintiff is concerned.*" (*Id.* at 6; emphasis in original). Thus even though the fair market value of the taxpayer's own obligations may be less than the face amount of the new debentures being used to retire them, the difference will not be treated as a deductible loss or discount if the plain-

tiff originally received consideration equal to the face amount of the obligations being replaced.

Even assuming the applicability of the above principles to the present case, however, the record discloses the existence of a deductible discount. The preferred and preference shares were originally issued in exchange for cash and property amounting to $45,323,846. Even if there is added to this figure the sum of $49,671,950 for accrued undeclared cumulative dividends,[9] the resulting total of $94,995,796 is substantially below the face amount of the debentures issued, i.e., $115,246,950.

Defendant nevertheless argues that plaintiff should not be permitted to deduct any part of the difference between face amount of the debentures, on the one hand, and any lesser value attributed to the preferred and preference shares received on the other, for the reason that the result would be to allow non-deductible expenditures to be converted into deductible ones by the simple expedient of issuing debt obligations instead of paying cash. Under defendant's view, by issuing debentures plaintiff extinguished matured obligations in satisfaction of which it would otherwise have paid cash, in which case it could not have derived any deductions from the transaction. Plaintiff's position is that the debentures were merely a substitute for cash, and that the debentures-for-stock arrangement, as the equivalent of a cash version of the same transaction, should entail similar tax consequences.

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[9] See note 8, *supra*.

The fallacy in defendant's approach, however, lies in its assumption that the 1947 transaction was a redemption in which plaintiff was using debentures instead of cash to redeem matured obligations that would total $115,246,950 if a cash redemption had been worked. As we have already pointed out, however, the exchange was not a redemption and the cash payment analogy therefore loses its force. Since the transaction amounts to a conversion of preferred stock and hopes for eventual payment of accrued accumulated dividends into creditors' claims, there is no reason to treat the issuance of debentures as a direct payoff of each of the elements of the call price that would be payable if there had been a redemption. In short if cash had been paid pursuant to the redemption provisions of the charter, there would not have been any deductible discount. But cash was not paid, and there was no redemption. Debentures were issued at a face value in excess of the consideration received for them, giving rise to deductible discount.

At the time when the preferred and preference shares were originally issued, Cities Service received certain cash and properties and assumed certain conditional obligations, i.e. (1) not to pay any dividends out of earnings or surplus to common stockholders as long as there were accrued but unpaid cumulative dividends on the preferred; (2) to say stated value plus accrued and unpaid dividends to preferred shareholders upon any liquidation, dissolution or winding up, whether voluntary or involuntary, be-

fore any payment to the common stock; and (3) to pay the stated call price, including premium, plus unpaid dividends, to preferred stockholders upon any call for redemption. By 1947, 14 years of dividends on the preferred shares had been passed, precluding any dividends from being paid to the common until the accrued cumulative dividends were declared and paid. However, plaintiff was not obligated to purchase its own ownership (i.e., its preferred and preference shares) and its obligation to pay dividends to such holders was at most contingent on the existence of earnings and whether the management in good faith determined that the earnings should not be used for more essential corporate purposes. Certainly plaintiff had the absolute right not to redeem its preferred and preference shares.

The effect of the 1947 exchange was a radical change in plaintiff's debt obligations. In lieu of a conditional obligation to pay dividends on the preferred and preference shares depending upon earnings and the management's good faith exercise of its discretionary powers, plaintiff now became firmly and unconditionally obligated to pay the face amount of the new debentures plus 3% interest annually on the unpaid balance. Even assuming *arguendo* a prior obligation to pay dividend arrearages, the maximum amount of the accrued dividends was $49,671,950, as against debentures in the face amount of $115,-246,950. Viewed in this light, plaintiff indeed suffered a loss when in 1953 and 1954 it paid more to retire certain of the debentures than it had received

for them. It is also clear that to allow plaintiff to deduct this loss is not to allow it to convert non-deductible expenditures into deductible expenditures by the simple expedient of paying in bonds rather than in cash. The "expedient" in question, if it can be so called, involved far more than the substitution of currencies urged by the defendant. It involved the assumption of enlarged and unconditional obligations by the plaintiff, as a result of which deductible losses have been realized.

How is the Loss or Discount to be Determined?

Reduced to simplest terms the deductible loss or discount is the "difference between what is given up and what is received" by the taxpayer. *Missouri Pacific R.R.* v. *United States*, Nos. 142-67 & 95-68 (Ct. Cl. 1970) Slip Op. at 10. In calculating that difference in the present case no disagreement exists as to the face amount of the new debentures or the amounts paid by plaintiff to repurchase some of them. It is equally clear that for present purposes the *minimum* amount which plaintiff may ascribe to the preference and preferred shares acquired by it is the original consideration received when the shares were issued, i.e., $45,323,846.[10] Furthermore, for the reasons we have already indicated, even if the market value of the shares at the time of the exchange had declined below their original issue price, plaintiff would be precluded from claiming the decline in

[10] It should be noted that the defendant has reserved the right to contest this figure. See page 31, *infra*.

value as a loss because, having received the cost price upon issuance of the shares, it had not actually suffered a loss to the extent of the market decline. *Erie Lackawanna R.R.* v. *United States*, 422 F.2d 425 (Ct. Cl. 1970).

Thus the original cost of the preferred and preference shares represents a floor, or minimum value, for determining plaintiff's loss or discount. Relying principally upon the Court of Claims' recent decisions in *Erie Lackawanna* and *Missouri Pacific*, *supra*, plaintiff contends that the original issue or cost price of the shares should also represent the ceiling. With this we disagree.

Although a taxpayer, upon issuance of bonds in exchange for its shares, may not claim a loss based upon a decline in the market price of the shares below the price realized by it upon their original issuance, *Erie Lackawanna*, *supra; Missouri Pacific*, *supra*, it does not follow that the shares or obligations cannot turn out to have a greater value to the taxpayer than their original issue price. In the present case, for instance, even though the accrued and unpaid accumulated dividends did not constitute a firm obligation for which the plaintiff had received any consideration, the preferred and preference shareholders could use the dividend provisions of the charter to preclude plaintiff's management from paying any dividends on the common and to restrict the uses to which plaintiff's earnings could be put. Furthermore, it is possible that circumstances might arise where

they could force the management to declare and pay part or all of the accrued dividends."

Thus, where a taxpayer receives its own shares in exchange for issuance of its debentures, the value of "what is received" for purposes of determining the deductible loss or discount may be higher (though not lower) than the original issue price of the shares. The actual value to the taxpayer can be determined only after consideration of all relevant data, including the market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects, and expert opinion. Although the market price would be relevant, especially since it might reflect the public's opinion as to shareholders' prospects for participating in future corporate distributions, it would not be conclusive. Furthermore, market prices for the period immediately prior to the exchange might in the present case be discountable for the reason that from the date when the details of the amended plan became public investors may have assessed the shares in terms of the debentures for which they would soon be exchanged. The market price of the shares may also be vulnerable on the ground that it represented trading in a limited number of shares, whereas the exchange was concerned with the retirement of the entire issue of preferred and preference stock. Nevertheless we believe that after consideration of such relevant factors as may be offered, including market price, it should be possi-

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[11] See note 8, *supra*.

ble to arrive at a figure representing the value to plaintiff of the shares in question. See, e.g., *Atchison, Topeka & Santa Fe Ry.* v. *United States*, 69-2 U.S.T.C. ¶ 9740 (D. Kans. 1969).

Affirmative Defenses

In its answer defendant contends that this court is without jurisdiction of certain of plaintiff's refund claims under 26 U.S.C. § 7422 [12] because of plaintiff's failure to file such claims with the Internal Revenue Service before instituting suit. More specifically, defendant urges that plaintiff has never filed (1) a loss-based claim for the taxable year 1953 under any measure of value; (2) a loss-based claim for the year 1954 on the original consideration measure; (3) a discount-based claim for either year for the unamortized portion of the discount attributable to debentures retired in those years; (4) a discount based claim for either year under either the original consideration or adjusted market value measures of

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[12] Section 7422(a) provides as follows:

"*No Suit Prior to Filing Claim for Refund.*—No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary or his delegate, according to the provisions of law in that regard, and the regulations of the Secretary or his delegate established in pursuance thereof."

value. It is not contested that plaintiff did file discount-based refund claims for both years under a market *price* measure of value, or that the 1954 claim was later amended to add a loss-based claim employing the original consideration measure of value.

While refund claimants are not entitled to rely at the trial stage upon theories of law or versions of the facts which they did not assert in their original claims for refunds, *Pelham Hall Co.* v. *Carney*, 111 F.2d 944 (1st Cir. 1940); *Nemours Corporation* v. *United States*, 188 F.2d 745, 750 (3d Cir.), *cert. denied*, 342 U.S. 834 (1951); 10 Mertens, Law of Federal Income Taxation § 58.17, not every variation between the original claim and the complaint in a civil suit thereon is fatal to recovery. As this Circuit has stated:

> "We think that [the 1939 Code's equivalent of § 7422] go[es] no further than to require the taxpayer to set forth facts sufficient to enable the Commissioner of Internal Revenue to make an intelligent administrative review of the claim."

Scovill Manufacturing Co. v. *Fitzpatrick*, 215 F.2d 567, 569 (2d Cir. 1954). See also 10 Mertens, Law of Federal Income Taxation § 58.21.

We think that the instant case comes well within the immaterial variance category. Without reaching the question of whether plaintiff's original refund claims could be held sufficient to support every one of its theories and proposed measures of recovery in this suit, it is clear that its discount-based claims

under a market price measure of the value of the preferred and preference shares received were more than adequate to apprise defendant of both the theory and measure of recovery on which we have proceeded in this opinion.

Conclusion

Although defendant has accepted plaintiff's calculation as to the original issue and adjusted market prices of the preferred and preference shares for purposes of our ruling on its motion for summary judgment, it has expressly reserved the right, in opposing plaintiff's similar motion, to challenge these figures and to exercise its rights under Rule 56(f), F.R.C.P., to cross-examine or depose the experts upon whom plaintiff relies. Upon plaintiff's motion for summary judgment an issue of fact is therefore raised as to the amount of the dollar value to plaintiff of the preferred and preference shares surrendered in exchange for defendant's issuance of its debentures in 1947.

Plaintiff's motion for summary judgment is therefore denied. Pursuant to Rules 56(c), (d), however, we conclude that the sole material fact actually controverted is the value to plaintiff of the preferred and preference shares received by it upon issuance of its debentures and that no genuine issue is presented as to all other material facts, which shall be deemed established. Accordingly a trial will be conducted as to the remaining issue, and once the value of the shares received has thus been determined,

any refunds due plaintiff will be determined by simple mathematical computation.

Defendant's motion is denied in all respects.

Settle order on notice.

/s/ Walter R. Mansfield
U.S.D.J.

Dated: July 23, 1970.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

67 Civ. 4606

CITIES SERVICE COMPANY, PLAINTIFF

—against—

UNITED STATES OF AMERICA, DEFENDANT

APPEARANCES:

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WYATT, District Judge,

This is a second motion by defendant for a summary judgment in its favor. Fed. R. Civ. P. 56. The motion must be denied.

The action is for refund of income taxes paid by plaintiff for the two years ending respectively on December 31, 1953 and December 31, 1954. 26 U.S.C. § 7422. Jurisdiction is asserted, and appears to exist, under 28 U.S.C. § 1346(a)(1).

Plaintiff in 1947 issued thirty year 3% debentures in exchange for shares of its own $6 preferred stock, $6 preference BB stock, and 60¢ preference B stock. By the terms of the indenture, plaintiff was required to retire annually $1,500,000 principal amount of debentures.

In 1953 and in 1954, plaintiff purchased in the open market, and retired, in excess of $1,500,000 principal amount of debentures.

Plaintiff asserts that when the debentures were issued in 1947 it received less in value for them than their face (principal) amount.

Starting from this assertion, plaintiff then has two alternative theories to support the present claim for income tax refund:

> first, that plaintiff paid more in the open market for the debentures retired in 1953 and

1954 than plaintiff had received for them on issuance in 1947 and that this difference is a "loss" deductible under 26 U.S.C. § 165(a); or second, that the debentures were issued in 1947 at a discount, the amount of which is deductible, prorated over the 30 year life of the debentures, under Treas. Reg. § 1.61-12(c)(3).

Defendant moved for summary judgment and the matter was heard by Judge Mansfield on February 10, 1970.

On July 24, 1970, Judge Mansfield filed a careful opinion, since reported at 316 F.Supp. 61. This opinion sets out the factual and legal background, which will not be repeated here.

The motion of defendant for summary judgment was in all respects denied.

Judge Mansfield further found that plaintiff was entitled to summary judgment as to all issues of law and as to all issues of material fact, except one: "the value to plaintiff of the preferred and preference shares received by it upon issuance of its debentures". 316 F.Supp. at 74.

An order was directed to be settled on notice.

It appears that defendant submitted a proposed order on October 16, 1970 containing a statement under 28 U.S.C. § 1292(b) to permit an interlocutory appeal; that plaintiff submitted a counter order on October 20, 1970; that defendant wrote to Judge Mansfield on November 30, 1970 advising him that defendant would make a second motion for summary judgment, stating that it seemed to be appropriate

"to delay any certification of issues for appeal until this motion is decided", and expressing the hope that Judge Mansfield would accept a reference of the second motion for summary judgment.

Defendant then made the present (second) motion for summary judgment. The Reply Memorandum for defendant (page 11) contains this sentence:

> "On December 18, 1970, the defendant was advised that Judge Mansfield would be unable to accept a reference of the motion."

This second motion for summary judgment by defendant then came on to be heard by me in the civil motion part on February 9, 1971.

On February 11, 1971, Judge Mansfield filed an order on his decision. The form of order was that submitted by plaintiff. There was no statement to permit an interlocutory appeal under 28 U.S.C. § 1292 (b).

This second motion of defendant for summary judgment is in actuality a motion to reargue the motion denied by Judge Mansfield. The procedure followed by the government is of doubtful propriety, to say the least. I decline to examine the merits of the decision of Judge Mansfield. I accept that decision as the law of the case in this Court. If the decision be wrong—and by no means do I suggest that it is wrong—in the fullness of time the government may secure a correction in the Court of Appeals.

The excuse of the government for this second motion for summary judgment is that on November

13, 1970 the Court of Claims handed down a second decision (on a motion for rehearing) in *Missouri Pacific R.R.* v. *United States*, 433 F.2d 1324. According to the government, under this decision "the value to plaintiff of the preferred and preference stocks received in exchange for its bonds was no less than the maturity value of these bonds" (Memorandum, pp. 3-4). The government points out that in *Missouri Pacific*, the Court concluded that the value of the stock given up in exchange for bonds "has authoritatively been found . . . [by the Interstate Commerce Commission] to be not less than the maturity value of the bonds exchanged" (433 F.2d at 1326). The government says that in the case at bar the SEC similarly found that the new debentures of plaintiff were the "equitable equivalent" of the preferred and preference shares in exchange. Thus, the government says that on the one issue left by Judge Mansfield for trial, defendant is entitled to summary judgment.

The argument for the government is without merit.

The second decision in *Missouri Pacific* has nothing whatever to do with the case at bar. This second decision accepted the reasoning of Judge Mansfield on *another* point, not now in issue here. The value of the stock there given in exchange had already been determined by the Interstate Commerce Commission; no trial was necessary to find this value. The Interstate Commerce Commission had made this determination (290 ICC at 670): ". . . the value

of the stock is fixed at $250 per share in new securities".

In the case at bar the inquiry is: did the SEC determine the value of the preferred and preference stocks of plaintiff received in exchange for its new debentures?

Judge Mansfield has already determined that the answer to this inquiry is "no". Among other things, his opinion stated (316 F.Supp. at 68):

> "Nor did the SEC's determination that the plan was fair and equitable to all parties and that the debentures were the 'equitable equivalent' of the rights surrendered imply that the debentures were worth their face value at the time of issuance. It merely meant that their discounted value was approximately equal to the value of the properties received in exchange."

The motion of defendant is in all respects denied.

SO ORDERED.

Dated: New York, New York
June 21, 1971

INZER B. WYATT
United States District Judge

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

67 Civ. 4606 (CHT)

CITIES SERVICE COMPANY, PLAINTIFF

—against—

UNITED STATES OF AMERICA, DEFENDANT

OPINION

TENNEY, J.

This is an action pursuant to 26 U.S.C. § 7422 (1970) and 28 U.S.C. § 1346(a)(1) (1970) for refund of income taxes paid by plaintiff for the calendar years 1953 and 1954. Plaintiff, in 1947, issued 30-year 3 percent debentures with a face value of $115,246,950 in exchange for shares of its own $6 preferred stock, $6 preference BB stock, and 60¢ preference B stock.[1] By the terms of the indenture,

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[1] The preferred stock $6 cumulative was preferred as to dividends over the two classes of preference stocks and the common stock, and the preference BB and preference B stocks ranking *pari passu*, were preferred as to dividends over the common stock.

On liquidation or dissolution, whether voluntary or involuntary, the preferred stock was entitled to $100 per share plus unpaid accrued dividends before any distribution was made to other stockholders and the BB and B preference stocks were entitled to $100 per share and $10 per share, respectively, plus unpaid accrued dividends, before any distribution could be made to the common stock.

The preferred, the BB preference and the B preference stock were subject to redemption, in whole or in part, at any time,

plaintiff was required to retire annually $1,500,000 principal amount of debentures. In 1953 and 1954 plaintiff purchased in the open market and retired in excess of $1,500,000 principal amount of debentures. Plaintiff asserts that when the debentures were issued in 1947 it received less in value for them than their face value, and alleges that the difference between the face amount of the debentures and the consideration received by it on the exchange is a "loss" within the meaning of 26 U.S.C. § 165(a) (1970), which loss may be realized as the debentures are redeemed or amortized over the life of the debentures. Treas. Reg. § 1.61-12(c)(3) (1968).

This case is before the Court pursuant to an order entered on February 11, 1971, by United States District Judge (now Circuit Judge) Walter R. Mansfield. The order was entered pursuant to an opinion dated July 23, 1970, in which Judge Mansfield denied motions for summary judgment made by plaintiff and defendant. *Cities Service Co.* v. *United States*, 316 F. Supp. 61 (S.D.N.Y. 1970). The order decreed:

> ". . . that this case be set down for trial in due course with the sole factual question to be resolved thereat being the value to plaintiff of the preferred and preference shares received by it in exchange for the issuance of its 3% Thirty Year Sinking Fund Debentures ("the Bonds") on May 27, 1947; and
>
> ". . . that . . . the bonds shall be deemed issued at a price equal to the value to plaintiff of

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by the payment of an amount equal to $112, $106 and $10.60 per share, respectively, plus unpaid accumulated dividends.

the preferred and preference stocks received in exchange for their issuance on May 27, 1947; and

". . . that . . . the value of those shares to plaintiff shall be no less than $45,323,846, the value of the consideration originally received for their issuance . . . ."

On February 9, 1971, defendant's second motion for summary judgment was heard by United States District Judge Inzer B. Wyatt and denied on June 21, 1971, in an opinion reaffirming Judge Mansfield's determination. *Cities Service Co.* v. *United States*, 330 F. Supp. 421 (S.D.N.Y. 1971).

Although both Judge Mansfield's and Judge Wyatt's opinions, findings of fact and conclusions of law are incorporated herein, it will be helpful to repeat certain of the conclusions reached by Judge Mansfield in order to define the specific issue remaining.

From the evidence before him, Judge Mansfield concluded, first, "that the shares were worth less than the face amount of the debentures", and, second, "that the 1947 exchange did not constitute a redemption". 316 F. Supp. at 66. "In conclusion we view the 1947 issuance of debentures as an exchange and not a redemption. . . . However one chooses to measure the consideration they gave up, there is every indication that it was substantially less than the face amount of the debentures they received." *Id.* at 69. On the motion for summary judgment, plaintiff, relying principally on the Court of Claims' decisions in *Erie Lackawanna R.R.* v. *United States*, 422 F.2d 425

(Ct. Cl. 1970) and *Missouri Pacific R.R.* v. *United States*, 427 F.2d 727 (Ct. Cl. 1970), *cert. denied*, 402 U.S. 944 (1971), argued not only that the original cost of the preferred and preference shares represented the minimum value for determining its loss or discount, but also that this figure represented the maximum. Judge Mansfield disagreed with the latter proposition holding:

> "Although a taxpayer, upon issuance of bonds in exchange for its shares, may not claim a loss based upon a decline in the market price of the shares below the price realized by it upon their original issuance, [citing *Erie Lackawanna* and *Missouri Pacific*, *supra*] it does not follow that the shares or obligations cannot turn out to have a greater value to the taxpayer than their original issue price". 316 F. Supp. at 72.

It is interesting to note that on the basis of Judge Mansfield's opinion the Court of Claims modified its prior opinion in *Missouri Pacific*, *supra*, and held that the original issue or cost price did not represent the ceiling value for the purpose of calculating debt discount. *Missouri Pacific R.R.* v. *United States*, 433 F.2d 1324 (1970), *cert. denied*, 402 U.S. 944 (1971). Judge Mansfield further observed that

> "even though the accrued and unpaid accumulated dividends did not constitute a firm obligation for which the plaintiff had received any consideration, the preferred and preference shareholders could use the dividend provisions of the charter to preclude plaintiff's manage-

> ment from paying any dividends on the common and to restrict the uses to which plaintiff's earnings could be put." 316 F. Supp. at 72.

He concluded that "[t]he actual value to the taxpayer can be determined only after consideration of all relevant data, including the market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects and expert opinion." *Id.* at 72-73.

In accordance with Judge Mansfield's opinion and the order entered pursuant thereto, plaintiff called three experts in the fields of corporate finance, value analysis, economics and business management and has submitted other evidence. These experts appraised the exchange from three different viewpoints:

> 1) The general economic aspects of the exchange, an analysis of the specific economic and financial benefits and burdens resulting to plaintiff therefrom and the net effect of the exchange in light of the prevailing economic conditions on May 27, 1947;
>
> 2) An economic and financial analysis of plaintiff and the securities involved to ascertain what value, if any, apart from the amount or value received when the preferred and preference shares were issued, accrued to plaintiff on account of the exchange; and
>
> 3) An analysis of the effect of the issuance of the debentures on plaintiff's financial and economic structure.

General economic aspects and specific benefits and burdens resulting to plaintiff from exchange.

According to plaintiff's expert, Dr. Jules Backman, there were, of course, benefits which accrued to plaintiff upon the exchange: it enabled plaintiff to conform to and comply with the Public Utility Holding Company Act; it got plaintiff the benefit of a tax deduction for interest payments; and the elimination of the preferred and preference stocks permitted plaintiff to pay dividends to the common stockholders if money were available for that purpose. It seems clear, however, that the net effect of the exchange was adverse to plaintiff. Plaintiff exchanged its senior stocks (*i.e.*, the preferred and preference stock) on which, except for one small payment, it had not paid a dividend since 1932 and on which, under normal circumstances, it would not be required to pay dividends for the foreseeable future, for debentures, fixed and determinable debt obligations with mandatory annual interest payments and mandatory sinking fund requirements. So although plaintiff became entitled to a tax deduction for the interest payments on the debentures, it was henceforth required to pay such interest in addition to having to establish a sinking fund to redeem the debentures. Whereas with the preferred and preference shares outstanding, plaintiff had had the continuing option to avoid paying out cash to its equity holders and to use the funds to pay off debts or to expand its plant and equipment, the exchange resulted in a constant cash drain on the company of

more than $3,600,000 annually. Moreover, the issuance of the debentures gave plaintiff an exceedingly high proportion of debt to equity capital, and the indenture of the new debt burdened plaintiff with additional restrictions on its future debt financing based upon an earnings level ratio.

Economic and financial analysis of plaintiff and the securities involved.

In his opinion Judge Mansfield noted that "the face amount of the debentures issued in 1947—$115,246,950—was identical with the cash amount that plaintiff would have been required to pay to the preference and preferred shareholders if it had chosen to redeem their shares." *Id.* at 66. Plaintiff's expert, William R. Field, broke down the principal amount in slightly greater detail as follows:

1)	Original discount on preferred and preference stock when issued	$ 13,366,154
2)	Stated call premium	6,885,000
3)	Accumulated dividend arrearages	49,671,950
4)	Original consideration for the issuance of the preferred and preference stock	45,323,846
		$115,246,950

In accordance with Judge Mansfield's decision, the original consideration, *i.e.*, $45,323,846, is the "floor" with respect to the issue before this Court. Accordingly, at trial plaintiff's expert directed himself to the question of whether plaintiff could have realized or acquired value on account of the excess between

the "floor" and a "ceiling" represented by the $115,246,950 of debentures. Insofar as the stated call premium of $6,885,000 was concerned, he was of the opinion that it was a "penalty" payable on redemption and not value received by plaintiff. Even if plaintiff had *liquidated*, the stockholders would not have received a call premium. Since it already has been held that there was no redemption, this premium would appear to have been a windfall for the stockholders.

The dividend arrearages of $59,671,950 present a more serious problem. It is not disputed that accumulated, undeclared dividends on preferred or preference stock do not constitute a binding legal obligation of plaintiff, unless the dividends were withheld in bad faith. *Id.* at 70 n. 8. Upon analysis of investor behavior, plaintiff's financial condition and the charter provisions relating to the preferred and preference stock, plaintiff's expert concluded that nothing of value was received by plaintiff on account of the accumulated, undeclared dividends. His conclusion that no value accrued on account of the arrearages was predicated upon the following factors:

1) Analysis of the market prices showed that investors were not anticipating the payment of arrearages. In the opinion of the expert, a comparison of the market activity and prices of the stock when dividends *were* being paid and arrearages *had not* accumulated, with such activity and prices when there were *no* dividends paid and arrearages *had*

accumulated, indicated that investors in plaintiff's preferred and preference stocks were *not* anticipating the payment of arrearages. The foregoing conclusion was corroborated by the expert's analysis of the price-yield ratios or relative yield factors of the preferred and preference stocks and the general yield percentages of other high grade preferred stocks using the stated dividend rate whether or not paid.

2) Analysis of plaintiff's financial structure indicated that it was not possible for it to pay the arrearages. Such analysis was predictable *inter alia* upon a study of plaintiff's annual earnings record, net income, accumulated arrearages, net income as a percentage of arrearages, net income available for dividend arrearages, after-tax interest coverage, and a comparison of plaintiff's financial situation with that of three independent yardstick groups of companies (*i.e.*, thirty petroleum companies, all natural gas companies reporting to the Federal Power Commission, and all Class A and B electric companies similarly reporting) to determine whether plaintiff was in such comparatively good financial condition that it could, should, or would pay the accumulated dividend arrearages. The yardstick companies were compared with plaintiff as to interest coverage, rates of return on equity capital and on total capital, relative percentages of net income plus interest as percentages of total income, interest as a percentage of average debt capital, long term debt capital as a percentage of total capital, and common and preferred capital as a percentage of total capital. The yard-

stick companies interest coverage for the period 1940-1946 greatly exceeded that of plaintiff, indicating a need for plaintiff to reduce debt charges and consequently to increase its coverage. Comparison of plaintiff with the yardstick companies as to rate of return earned on average common and preferred capital and rate of return earned on average total capital showed that plaintiff's earnings were substandard. Net income as a percentage of total income (net income plus interest), interest as a percentage of net income plus interest, and interest as a percentage of average debt capital when compared as between plaintiff and the yardstick companies indicated that plaintiff's relative net income was extremely low or, conversely, that its debt structure and interest charges were very high when compared to other competitive companies. Likewise, the paralleling of capital structure ratios and the percentages of total capital represented by debt and equity evidenced the high debt or low equity level of plaintiff compared to the criteria groups. Plaintiff's capital structure proved to be several times heavier with debt than that of the yardstick petroleum companies and significantly heavier than the yardstick gas and electric companies, while its equity as a percentage of total capital was much lower than that of the yardstick companies. On the basis of the foregoing, plaintiff's expert concluded: (a) that plaintiff was not in a position either to pay the dividend arrearages or to issue debt obligations for them; (b) that the retirement and cancellation of the stock did not

release to, or provide plaintiff with, any additional funds for the payment of its obligations or for dividends to common stockholders; (c) that since the stock "disappeared" upon the exchange, no "investment value" accrued; and (d) that cancellation of the stock converted into a firm, binding debt obligation which must be paid at all events, a contingent claim relating only to relative priorities among shareholders in any distribution of earnings which, if left to its own devices plaintiff most likely would have disposed of at little cost to itself.

Effect of the issuance of the debentures on plaintiff's financial and economic structure.

Finally, plaintiff presented through the expert testimony of William A. Gill an analysis of the effect of the issuance of the debentures on its financial and economic structure. It was the expert's opinion that as a result of the exchange plaintiff's financial condition had deteriorated.

It should be noted that at the trial none of plaintiff's three experts offered an opinion as to the "fair market value" of the preferred and preference stock as of May 27, 1947, but only as to the "value to plaintiff" of such stock. As will appear *infra*, however, such opinion evidence of "fair market value", not specifically rebutted by any of the parties, does form a part of the trial record herein.

Defendant relied upon the testimony of three expert witnesses, as did plaintiff. Although the issue before the Court was the value *to plaintiff* of the

preferred and preference shares, none of defendant's witnesses directed himself to that issue but spoke of "investment values" to the stockholders, or benefit to the common stockholders. Two of defendant's experts went so far as to testify that the value to the taxpayer (by way of value to the common stockholders) was in excess of the face amount of the debentures, while the third expert testified that plaintiff would in his opinion clear up the accumulated arrearages within ten years, and, accordingly, that the value of the preferred and preference stock to plaintiff was $115,246,950—*i.e.*, the face value of the debentures.

The Court rejects the opinions of defendant's experts in their entirety. Their opinions cannot withstand analysis, are based upon false premises, or fail to reach the issue herein—as has clearly been demonstrated by plaintiff in its "Requested Findings of Fact and Conclusions of Law and Brief in Support Thereof" at 37-59 and "Reply Brief" at 12-17.

Despite the failure of the experts for either party to fix during the trial the fair market value of the stock on May 27, 1947, there is, as has been indicated, expert evidence on record fixing such value. In its papers on the motion for summary judgment before Judge Mansfield *plaintiff asserted that the fair market value of the preferred and preference stock at the time of the exchange was $86,313,600.* (Def.'s Exh. B, "Rule 9(g) Statement" ¶ 51.) More specifically plaintiff put forward the following valuations as of May 27, 1947:

Class of Stock	No. of Shares	Fair Market Value Per Share	Aggregate Fair Market Value
$6 Preferred	560,000	$147.50	$82,688,500.00
60¢ Preference B	86,000	$ 13.75	1,182,500.00
$6 Preference BB	17,700	$138.00	2,442,600.00
		Total	$86,313,600.00

The basis for the above valuation was an affidavit of William A. Gill dated January 27, 1970, and supporting data. (Def.'s Exh. B, "Rule 9(g) Statement" Exh. 1.) Other than a passing reference, no mention of this valuation was made by either party in its briefs before this Court, although the Court specifically called it to the attention of counsel in the course of the trial (Tr. 241-42). Moreover, pursuant to Judge Mansfield's opinion, defendant had "the right . . . to challenge these figures and to exercise its rights under Rule 56(f), F. R. Civ. P., to cross-examine or depose the experts upon whom plaintiff relies." 316 F. Supp. at 74. Gill's expert opinion remains unrebutted, plaintiff now adhering to its claim that the "floor" of $45,323,846 is determinative, whereas defendant maintains that the "ceiling" of $115,246,950 or some greater figure should control. In this respect plaintiff apparently has abandoned the first of two theories in support of its claim. As stated by Judge Mansfield:

> "Plaintiff advances two theories in support of its claim to a tax deduction arising from its repurchase of debentures in 1953 and 1954.

Both theories are based on plaintiff's contention that it paid more to redeem the debentures than it received in exchange for them upon issuance in 1947. What it received—the issue price of the debentures—plaintiff contends, was either the fair market value of the preferred and preference shares surrendered upon the 1947 exchange ($86,313,600.00), *or* the fair market value of the cash and properties originally paid in upon issuance of those shares in prior years ($45,323,846.00). The first theory holds simply that a deductible loss was realized upon repurchase of debentures at a price higher than the price realized upon their issuance. The second theory, based on Reg. § 1.61-12, holds that the issuance of the debentures at less than face in 1947 gave rise to bond 'discount' within the meaning of that Regulation, entitling plaintiff to prorate or amortize the discount over the life of the bonds and to deduct both the amortization thereof for the taxable years in question and the unamortized portion of the discount attributable to the debentures retired in those years. Each theory produces two figures for the proposed deduction, depending on which of the two measures of the issue price of the debentures in 1947 is employed. See Complaint ¶¶ 35-39, 44-48." *Id.* at 65.

While the correct basis for determining loss or discount in situations of this kind is not entirely clear, and there is authority for each of the two theories postulated by plaintiff, such basis would appear to be the difference between the issue price originally received by the taxpayer (plaintiff) for the

preferred and preference stock *or* the fair value of such stock to the taxpayer at the time of the exchange, whichever is higher, and the face value of the debentures. *See Gulf, Mobile & Ohio R.R.* v. *United States*, 339 F. Supp. 489 (S.D. Ala. 1972) (containing a discussion of the pertinent cases in chronological order). While there is authority for the proposition that value at time of exchange is irrelevant when a corporation is retiring its own stock rather than acquiring the stock of some other entity or retaining its own reacquired stock—*Erie Lackawanna R.R.* v. *United States, supra*, 422 F.2d 425—later authority is to the contrary. *Missouri Pacific R.R.* v. *United States, supra*, 433 F.2d 1324. Indeed, in *National Alfalfa Dehydrating & Milling Co.* v. *Commissioner*, 472 F.2d 796 (10th Cir. 1973) the court found, with one dissent, that an allowable discount occurred when the taxpayer issued $50 debentures in exchange for $50 par value preferred stock when at the time of the exchange the fair market value of the preferred stock was only $33 per share, even though the taxpayer originally had received $50 per share on issuance of the preferred. While this holding runs counter in one respect to what this Court has suggested is the correct basis for determining loss or discount, it is not relevant to the instant case since the value herein in any event cannot be less than what plaintiff originally received.

Returning to the appraisal of William A. Gill dated January 27, 1970, referred to hereinbefore, among

the facts and circumstances which he considered were

> "a) The economy of the United States during the period 1930 through 1947, inclusive. . . .
>
> "b) The history of the public utility industry with particular emphasis on its experience under the Public Utility Holding Company Act of 1935. . . .
>
> "c) The history of Cities Service Company with particular emphasis on: the history and nature of its business; its experience under the Public Utility Holding Company Act of 1935; its operating results over the period 1935 through 1946, inclusive; its capital structure from inception through May 27, 1947; and the trading activity in its various securities over the 1935-1947 period. . . ." (Def.'s Exh. B, "Rule 9(g) Statement" Exh. 1, Gill Affid. ¶ 15.)

After consideration of these and other factors he concluded:

> "(a) In general, the financial condition of Cities Service improved significantly over the period January, 1935 to October 31, 1946. Nonetheless, at all times pertinent to the period of investigation, analysis, and study, the preferred and preference shares of Cities Service, were speculative in nature. While the market prices on the New York Stock Exchange for these preferred and preference shares were supported by active trading during the period January, 1943 through May,

1947. [sic] However, from November 20, 1946 these prices were dependent on the value of the consideration to be received in exchange for such shares; i.e. the 3% Sinking Fund Debentures in the aggregate principal amount of $115,246,950.

"(b) That a valuation of the Cities Service preferred and preference shares as of May 27, 1947 predicated on the plan of simplification as amended fails to reflect the true inherent worth of such shares in light of the fact that from November 20, 1946 to May 27, 1947, the value of these shares was totally dependent upon the value of the announced consideration to be received in exchange therefor; i.e. the new Cities Service Debentures.

"(c) In order to determine the fair market value of the Cities Service preferred and preference shares on their own merits as a security as of May 27, 1947, it is necessary to analyze such shares at that point in time prior to any proposed plan of simplification.

"(d) That in his opinion as of May 27, 1947, the fair market value of the Cities Service preferred and preference shares, on their own merits as a security, without reference to any announced plan of simplification, was as set forth below:

Security	Fair Market Value
$6.00 Preferred	$147.50 per share
$6.00 Preference BB	138.00 per share
$0.60 Preference B	13.75 per share"

(*Id.* at ¶ 20.)

Plaintiff contended, on the motion for summary judgment, and defendant provisionally conceded for the purpose of that motion, "that at the time of the exchange in 1947 the aggregate fair market value of the preferred and preference shares was $86,-313,600.00" based on the Gill appraisal. 316 F. Supp. at 65. Does such "fair market value" constitute the "value of plaintiff" which is the issue before this Court? It seems clear that Gill's appraisal was based on "consideration of all relevant data, including the market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects and expert opinion." *Id.* at 73. Furthermore, although, as Judge Mansfield emphasized, market *price*, while relevant, would not be conclusive (*Id.*), the average market price for the stocks concerned on November 20, 1946, based on the average of the high and low for the week preceding and following that date, was:

$6.00 Preferred	$149.375
$6.00 Preference BB	$145.375
60¢ Preference B	$14.6875

Obviously, after November 20, 1946, when the original plan was proposed, the market price was dependent on the value of the consideration to be received in exchange for the stock, and nowise constituted a measure of the "value to plaintiff" of the stock, and Gill recognized this in making his appraisal. Furthermore, the average market price for the stock in 1946 was:

$6.00 Preferred	$145.50
$6.00 Preference BB	$136.00
60¢ Preference B	$13.375

Thus it appears that, while the average market price for the period immediately preceding and following the submission of the plan of November 20, 1946, exceeded Gill's determination of a fair market value, the average market price during 1946 was less than that fair market value with respect to each class of stock. Furthermore, the market must have been aware of the situation involving plaintiff well before this time.

The issue resolves itself, accordingly, to the alternative valuations referred to by Judge Mansfield: the fair market value of the stock surrendered upon the 1947 exchange ($86,313,600.00) *or* the fair market value of the cash and properties originally paid in on the issuance of the stock ($45,323,846.00).[2] The basic determination is a legal one and, on the basis of the authorities cited herein, requires the rejection of the second alternative.

Accordingly, the Court finds that the value to plaintiff of the preferred and preference shares received

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[2] The $45,323,846.00 figure was subject to defendant's right to contest its accuracy. 316 F. Supp. at 72 n.10. Although defendant elicited from plaintiff's expert Field an admission that he had accepted Judge Mansfield's figures without independent investigation, this would scarcely constitute a satisfactory exercise of its right to contest accuracy. However, in view of the determination reached herein, whether the $45,323,846.00 figure or the stated value of $58,690,000.00 is the correct "floor" is irrelevant.

by it in exchange for the issue of its 3 percent Thirty Year Sinking Fund Debentures on May 27, 1947, was $86,313,600.00, said valuation being computed as follows:

Class of Stock	No. of Shares	Value Per Share	Total Fair Value
$6.00 Preferred	560,000	$147.50	$82,688,500.00
$6.00 Preference BB	17,700	$138.00	2,442,600.00
60¢ Preference B	86,000	$13.75	1,182,500.00
		Total	$86,313.600.00

Submit final judgment in conformity herewith and with the prior orders entered herein on twenty (20) days notice.

Dated: New York, New York
June 11, 1973

CHARLES H. TENNEY
U.S.D.J.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

67 Civ. 4606 (CHT)

CITIES SERVICE COMPANY, PLAINTIFF

—*v*—

UNITED STATES OF AMERICA, DEFENDANT

NOTICE

SIRS:

PLEASE TAKE NOTICE that on October 17, 1973, pursuant to the opinion of Judge Charles H. Tenney dated June 11, 1973, the attached proposed Judgment with computations will be filed on behalf of plaintiff, Cities Service Company, in the United States District Court for the Southern District of New York. Said proposed Judgment with attached Exhibit "A" (with Schedules I and II) and Exhibit "B", shows the amount due and owing from defendant, United States of America, to plaintiff, Cities Service Company, on account of the overpayment of Federal Income taxes for the years 1953 and 1954, plus costs.

PLEASE ALSO TAKE NOTICE that pursuant to Judge Tenney's opinion dated June 11, 1973, you will have twenty (20) days to respond to this notice.

Dated: New York, New York
October 17, 1973

Respectfully submitted,

/s/ Thomas E. Tyre
THOMAS E. TYRE
345 Park Avenue
New York, New York 10022
Tel: 593-0200
Attorney for Plaintiff

TO:

Paul J. Curran, Esq.
United States Courthouse

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 162, 387—September Term, 1974

(Argued October 7, 1974 Decided December 13, 1974)

Docket Nos. 74-1221, 74-1490

CITIES SERVICE COMPANY,
PLAINTIFF-APPELLEE-APPELLANT

v.

UNITED STATES OF AMERICA,
DEFENDANT-APPELLANT-APPELLEE

Before:

KAUFMAN, *Chief Judge*,
SMITH and TIMBERS, *Circuit Judges*

Cross-appeals from judgment entered in tax refund action after bench trial in the Southern District of New York, Charles H. Tenney, *District Judge*, 362 F.Supp. 830, awarding taxpayer recovery of federal corporate income taxes and interest for the calendar years 1953 and 1954 in amount of $1,371,-

397.91 claimed to have been erroneously assessed and collected, the said opinion of Judge Tenney having incorporated findings of fact and conclusions of law set forth in prior opinions by Walter R. Mansfield, then *District Judge*, 316 F.Supp. 61, and by Inzer B. Wyatt, *District Judge*, 330 F.Supp. 421.

Affirmed in part; reversed and remanded in part.

DANIEL H. MURRAY, II, Asst. U.S. Atty., New York, N.Y. (Paul J. Curran, U.S. Atty., John W. Nields, Jr., Mel P. Barkan and Samuel J. Wilson, Asst. U.S. Attys., on the brief), *for Defendant-Appellant-Appellee.*

THOMAS E. TYRE, New York, N.Y. (James W. Robinson, Casey Craig & Constance, and Frueauff, Farrell, Sullivan & Bryan, New York, on the brief), *for Plaintiff-Appellee-Appellant.*

TIMBERS, *Circuit Judge*:

On these cross-appeals from a judgment entered November 20, 1973 in a tax refund action after a bench trial in the Southern District of New York, Charles H. Tenney, *District Judge*, 362 F.Supp. 830,[1]

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[1] Judge Tenney's opinion incorporated the findings of fact and conclusions of law set forth in two prior district court opinions in this refund action: one filed July 23, 1970 by Walter R. Mansfield, then *District Judge*, 316 F. Supp. 61, and the other filed June 21, 1971 by Inzer B. Wyatt, *District Judge*, 330 F. Supp. 421.

awarding the taxpayer, Cities Service Company (Cities), recovery of federal corporate income taxes and interest for the calendar years 1953 and 1954 in the amount of $1,371,397.91 claimed to have been erroneously assessed and collected, the essential questions are:

(1) Whether the district court correctly determined that Cities' exchange of its debentures for its outstanding preferred stock resulted in a deductible debt discount.[2]

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[2] Cities claimed a deduction alternatively under Section 163 (a) of the 1954 Code (for interest paid) or under Section 165(a) of the 1954 Code (for a loss sustained). We set forth both provisions here. Since, however, the Supreme Court in *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, —— U.S. —— (1974), 42 U.S.L.W. 4798, 4801-02 (U.S. May 28, 1974), established that the two theories are merely alternative descriptions of the same economic reality, we believe that they cannot lead to different tax consequences. Accordingly, we find it necessary to discuss only the discount theory.

Internal Revenue Code of 1954, § 163(a), 26 U.S.C. § 163 (a) (1970) [formerly Int. Rev. Code of 1939, § 23(b), 26 U.S.C. § 23(b) (1952)], provides:

"§ 163. Interest

(a) General rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

Internal Revenue Code of 1954, § 165(a), 26 U.S.C. § 165 (a) (1970 [formerly Int. Rev. Code of 1939, § 23(f), 26 U.S.C. § 23(f) (1952)], provides:

"§ 165. Losses

(a) General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."

(2) Whether the district court correctly determined the appropriate measure of that debt discount.

(3) Whether the district court correctly determined, in computing the deduction to be allowed to Cities for the years 1953 and 1954, that there should be excluded any amortization of debt discount attributable to the pre-1953 years since Cities did not claim such a deduction in its pre-1953 returns.

For the reasons below, we affirm the district court's determinations that the transaction did result in a debt discount which is allowable as a deduction and that there should be excluded any amortization of debt discount attributable to the pre-1953 years; but we reverse and remand for a redetermination of the appropriate measure of the debt discount to be deducted.

I. Prior Proceedings and Claims of the Parties

In view of the full exposition of these matters in the opinions of the district court referred to above, it is sufficient for our purpose briefly to summarize only those prior proceedings, claims of the parties and facts necessary to an understanding of our rulings below.

In 1941, Cities Service Company, a Delaware corporation, became a registered holding company under the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 et seq. (1970). Pursuant to Section

11(e) of the Holding Company Act, 15 U.S.C. § 79k (e),[3] Cities was required to simplify its corporate and capital structures. It submitted a plan which in due course was approved by the SEC as amended after hearings as to its fairness. The plan ultimately was enforced by the court. *In re Cities Service Co.*, 71 F.Supp. 1003 (D. Del. 1947).

The amended plan provided for prompt cash redemption of certain outstanding debentures and the issuance of new 30-year 3% sinking fund debentures in exchange for all of Cities' outstanding preferred and preference stock (three classes).[4] The aggregate

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[3] The so-called "death sentence" provision.

[4] When the plan became effective on May 27, 1947, pursuant to the order of the Delaware District Court, *In re Cities Service Co., supra,* Cities had outstanding three separate classes of preferred and preference stock: (1) preferred stock; (2) preference B stock; and (3) preference BB stock.

The preferred class consisted of 560,600 shares of $6.00 cumulative preferred stock carrying an annual dividend of $6.00 and callable at Cities' option at $112 per share ($100 stated value, plus $12 call premium), together with accumulated and unpaid dividends. As of May 27, 1947, each share of preferred was carrying $84.50 in dividend arrearages. The redemption price for each share of preferred was $196.50. The total redemption price for the 560,600 shares outstanding was $110,157,900.

The preference B class consisted of 86,000 shares of 60 cents cumulative no par stock carrying an annual dividend of 60 cents and callable at Cities' option at $10.60 per share ($10 stated value, plus 60 cents call premium), together with accumulated and unpaid dividends. As of May 27, 1947, each share of preference B stock was carrying $8.75 in dividend arrearages. The redemption price for each share of preference

face amount of the new debentures ($115,246,950) was equal to the stated value [5] of the preferred and preference stock ($58,690,000), plus the call premiums ($6,885,000), plus dividend arrearages accumulated over 14 years ($49,671,950). Each share of each class of the preferred and preference stock was to receive precisely its call price in face amount of new debentures in the exchange.

By the terms of the indenture under which the debentures were issued, Cities was to retire at least $1,500,000 in principal amount of the debentures annually through a sinking fund. Accordingly, during 1953 it purchased $1,519,500 in face amount of the debentures at a cost of $1,398,357.39; and during 1954 it purchased $1,805,900 in face amount of the debentures at a cost of $1,786,569.02.

Cities paid its taxes for the years 1953 and 1954. It then filed a claim for refund with the District

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B was $19.35. The total redemption price for the 86,000 shares outstanding was $1,664,100.

The preference BB class consisted of 17,700 shares of $6 cumulative no par stock carrying an annual dividend of $6 and callable at Cities' option at $106 per share ($100 stated value, plus $6 call premium), together with accumulated and unpaid dividends. As of May 27, 1947, each share of preference BB stock was carrying $87.50 in dividend arrearages. The redemption price for each share of preference BB was $193.50. The total redemption price for the 17,700 shares outstanding was $3,424.950.

See 316 F. Supp. at 64-65 (Mansfield, *J.*).

[5] The three classes of preferred and preference stock originally were issued by Cities at various times for cash and properties having an aggregate fair market value of $45,323,846 (the original consideration).

Director, asserting the position summarized below. When no action had been taken with respect to its claim for 1953 after six months and when its claim for 1954 had been disallowed,[6] Cities commenced the instant refund action.[7]

Cities' essential claim is that it received less in value for the debentures than their face amount when they were issued on May 28, 1947 in exchange for its outstanding preferred and preference stock. In short, it says that it issued the debentures at a discount. More specifically, it contends that it received either $45,323,846, the fair market value of the cash and properties originally paid in upon issuance of the preferred stock, or $86,313,600,[8] the fair market value of the preferred stock surrendered in the 1947 exchange.

Starting with this premise that the debentures were issued at a discount, Cities urged two alternative theories in the district court in support of its claim for a refund. They were summarized by the district court as follows:

> "The first theory holds simply that a deductible loss was realized upon repurchase of debentures at a price higher than the price realized upon

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[6] Int. Rev. Code of 1954, § 6532(a), 26 U.S.C. § 6532(a) (1970).

[7] Pursuant to Int. Rev. Code of 1954, § 7422, 26 U.S.C. § 7422 (1970), and 28 U.S.C. § 1346(a) (1970).

[8] Although Cities alleged in its complaint that this value was $84,459,215.52, before us it has adopted the district court's figure of $86,313,600. 362 F. Supp. at 835-38 (Tenney, *J.*).

> their issuance [Int. Rev. Code of 1954, § 165 (a)]. The second theory, based on Reg. § 1.61-12 [now Treas. Reg. § 1.163-3(c)(1) (1968)], holds that issuance of the debentures at less than face in 1947 gave rise to bond 'discount' within the meaning of that Regulation, entitling plaintiff to prorate or amortize the discount over the life of the bonds and to deduct both the amortization thereof for the taxable years in question and the unamortized portion of the discount attributable to the debentures retired in those years. Each theory produces two figures for the proposed deduction, depending on which of the two measures of the issue price of the debentures in 1947 is employed [$45,323,846 or $86,313,600]. . . ." 316 F.Supp. at 65 (Mansfield, *J.*).

The district court summarized the government's position with respect to both theories as follows:

> "Defendant's answer to both theories is the same: the debentures were issued at face value. Hence no discount arose from the exchange, and since the consideration received for the debentures equalled their face value, no loss was sustained when plaintiff repurchased them at less than face in 1953 and 1954. Defendant also contends that even if the debentures were issued at less than face, the differential is not deductible discount." *Id.*

The positions of the parties as summarized above have continued to remain substantially the same.

On the first round in the district court—on cross-motions for summary judgment—Judge Mansfield rejected the government's claim that the transaction

was a redemption and concluded that, no matter what value was assigned to the consideration given up by the preferred shareholders and received by Cities in the exchange, "there is every indication that it was substantially less than the face amount of the debentures they received." 316 F.Supp. at 69. The court went on to reject the analogous theory that to permit a deduction would allow Cities to convert non-deductible into deductible expenditures by issuing debentures instead of paying cash to extinguish matured obligations, i.e. calling the preferred by issuing bonds instead of paying cash. *Id.* at 71.

The court further held that the 1947 exchange effected a real alteration in Cities' liabilities since the obligation to pay dividends on the preferred which depended upon earnings and management's good faith exercise of its discretion to declare dividends was converted into an unconditional commitment to pay the face amount of the new debentures plus 3% annual interest. It held that Cities was entitled to a deduction, but upon which of the two theories urged by Cities the court did not specify. *Id.* at 71-72.

Finally, the court concluded that the sole material fact actually controverted was the value to Cities of the preferred and preference shares received by it in the exchange. As to this, it stated that the minimum was the value of the original consideration received when the shares were issued, $45,323,846; but that the actual value to Cities could be determined only after consideration of all relevant data, including the market value of the shares, the financial condition

of Cities at the time of the exchange, its profits prospects and expert opinion. The court noted that while the market price of the shares would be relevant, it was not conclusive. Accordingly, a trial was ordered solely on the issue of the value to Cities of the preferred and preference stock at the time of the exchange. *Id.* at 72-74.

On the second round in the district court—on the government's second motion for summary judgment —Judge Wyatt reaffirmed Judge Mansfield's determination and denied the motion. 330 F.Supp. 421.

The third round in the district court was a bench trial before Judge Tenney on the issue previously ordered by Judge Mansfield to be tried. On the issue, Cities claimed the value it received on the exchange was the original consideration paid in for the preferred, $45,323,846; the government claimed that the value was the aggregate face amount of the debentures, $115,246,950. Judge Tenney held that the value to Cities of the preferred and preference stock received on the exchange was its fair market value, $86,313,600.[9] 362 F.Supp. at 838. Judgment was entered for Cities based on the discount theory.[10]

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[9] This was the figure which Cities had contended, in its papers before Judge Mansfield on its original motion for summary judgment, was the fair market value of the preferred and preference stock. Neither party rebutted it at trial.

[10] Judge Tenney noted that Cities apparently had abandoned its theory of loss through retirement of its debentures. *Id.* at 835. His judgment computation is based only on a debt discount amortization theory. See Treas. Reg. §§ 1.163-3(a), (c)(1) (1968). On appeal, Cities claims that it did not abandon its loss theory.

Both sides have appealed. The time for filing briefs was extended to await the Supreme Court's decision in *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, —— U.S. —— (1974), 42 U.S.L.W. 4798 (U.S. May 28, 1974).

On this appeal, the government argues that *National Alfalfa* holds that there can be no deductible bond discount when a corporate taxpayer issues debentures for its outstanding preferred stock. Cities argues that the Court's decision does not preclude such deduction; that the amount it received for the debentures was the amount originally paid in for the preferred, $45,323,846, or, in the alternative, the fair market value of the preferred, $86,313,600; and that the district court erred in excluding pre-1953 amortization from the tax refund.

II. Deductibility of Debt Discount

Debt discount typically results from the sale by an issuer of its debt obligation on the market at an issue price below the face amount of the obligation. The difference is referred to as the discount.

Although no provision of the Internal Revenue Code in so many words allows a deduction for debt discount, it was settled that such discount is amortizable and deductible over the life of the indebtedness if the debt obligation was issued for cash. *National Alfalfa, supra*,—U.S. at—, —, 42 U.S.L.W. at 4800-01; *Chock Full O' Nuts Corp.* v. *United States*, 453 F.2d 300, 301-02 (2 Cir. 1971); Treas.

Reg. § 1.163-3(a)(1)(1968). The Supreme Court has not decided the general question whether deductible debt discount results when bonds have been issued for property other than cash. *National Alfalfa, supra,* —— U.S. at ——, 42 U.S.L.W. at 4801. The decisions of other courts on this issue are split. See cases cited *id.* at ——, 42 U.S.L.W. at 4801. Our Court, however, has held that such a deduction is allowable at least where the bonds were issued for tangible property. *Nassau Lens Co.* v. *Commissioner,* 308 F.2d 39 (2 Cir. 1962).

In the instant case, Cities issued new debentures for its own outstanding preferred stock. The face amount of these debentures equalled the aggregate of the stated value, accrued dividends and call premiums on the preferred. The government argues before us, as it did in the district court, that, since none of these items—excess of stated value over original consideration,[11] dividends or call premiums—would have been deductible by Cities had it paid cash for the preferred, to allow a deduction here would permit a taxpayer to convert non-deductible into deductible expenditures by the simple expedient of issuing debentures or bonds instead of paying cash for its preferred.

In effect, the government says that we must look at the transaction as if cash had been paid and the preferred had been redeemed. The district court re-

[11] Referring to Cities' contention that the issue price of the debentures was the original consideration paid in for the preferred.

jected this analogy. 316 F.Supp. at 71. In view of the Supreme Court's decision in *National Alfalfa*, we agree with the district court and affirm its determination in this respect.

The corporate taxpayer in *National Alfalfa* issued 18-year 5% sinking fund debentures, each $50 debenture to be exchanged for one share of outstanding $50 par 5% cumulative preferred (callable at the time of the exchange at $51). The holder of each share of preferred also received a warrant to purchase one-half share of common at $10 per share in lieu of a $10 dividend arrearage on the preferred. The taxpayer claimed a deduction under Int. Rev. Code of 1954, § 163(a), 26 U.S.C. § 163(a) (1970), for amortizable debt discount measured by the difference between $33 per share, the asserted market value of the preferred on the date of the exchange, and $50, the face value of the debentures. The taxpayer urged the Supreme Court to look to the "economic realities" of the transaction to determine whether deductible debt discount resulted from the exchange. The taxpayer contended that, if it had gone into the marketplace and issued $50 debentures for $33 in cash and then had used those funds to purchase its outstanding preferred, it would have been entitled to a deduction for debt discount in amount of $17 per debenture. In rejecting this contention, the Court reasoned that:

> "[I]t would require rejection of the established tax principle that a transaction is to be given its tax effect in accord with what actually oc-

curred and not in accord with what might have occurred. . . ." —— U.S. at ——, 42 U.S.L.W. at 4802.

Since the taxpayer in fact had not gone into the market and had not acquired the funds to purchase the preferred, the Court was unwilling to speculate as to what would have occurred had it done so.

The government's argument in the instant case is essentially the same as it urged in *National Alfalfa*. It asks us to view the exchange as if Cities had paid cash for the preferred and preference stock it received. But Cities would have obtained such cash only through the hypothetical venture into the marketplace which the Court rejected in *National Alfalfa*. Cash in fact was not paid here. We decline the government's invitation to postulate the tax consequences of the exchange on a hypothetical cash transaction which never occurred.

As Justice (then Judge) Marshall pointed out in *Nassau Lens Co.* v. *Commissioner, supra*, 308 F.2d at 44:

> "Surely a promise today to pay $150,000 in ten years is not presently worth $150,000 either in property or cash."

In the instant case, Cities in 1947 promised to pay $115,246,950 in thirty years plus 3% annual interest. This promise cannot be equated with an actual cash payment of that amount in 1947. We hold that the tax consequences of the exchange must be determined on the basis of what actually occurred and

not what might have occurred. *Cummings* v. *Commissioner*, —— F.2d ——, —— (2 Cir. 1974), slip op. 181, 191-92 (October 31, 1974) (Smith, *J.*, concurring).

We turn now to the government's more forceful argument based on what actually occurred here: the exchange of Cities' debentures for its outstanding preferred. This corresponds closely to what occurred in *National Alfalfa*. The Court's statement of the issue there is substantially what is before us here:

> "[W]hether debt discount arises where a corporate taxpayer issues a debt obligation in exchange for its own outstanding preferred shares." —— U.S. at ——, 42 U.S.L.W. at 4801.

In *National Alfalfa*, the Court held that the transaction there involved did not result in debt discount deductible to the taxpayer. The government would have us read that decision so broadly that debt discount may *never* result from the exchange by a taxpayer of its debentures for its own outstanding preferred stock. We decline to do so.

In *National Alfalfa*, the Court focused on the economic similarity between bond discount and stated interest. It noted that there had been some confusion as to whether such discount was properly characterized as "interest paid for the use of money" or "loss resulting from the funding operation." It concluded that "the relevant inquiry in each case must be whether the issuer-taxpayer has incurred, as a result of the transaction, *some cost or expense of ac-*

quiring the use of capital." —— U.S.L.W. at 4802 (emphasis added).

The Court held that the taxpayer there had not incurred any additional cost for the use of capital by its exchange of $50 5% debentures for $50 5% preferred shares. The principal amount and interest rate on the debentures and the preferred were the same. The sinking fund provisions of both were comparable. The amount originally paid in for the preferred equalled the principal amount of the debentures—the ultimate obligation. The preferred was obtained merely by cancelling the $50 obligation per share on its equity account and transferring that amount to its debt account. As the Court observed:

> "The cost of the capital invested in the corporation was the same whether represented by the preferred or by the debentures, and was totally unaffected by the market value of the shares received at the time of the issuance of the debentures. Accordingly, while recognizing the alteration which did occur in the corporation's capital structure, we conclude that the substitution by [the taxpayer] of its debentures for its previously outstanding preferred, without more, did not create an obligation to pay in excess of an amount previously committed, or establish the base upon which debt discount can arise." —— U.S. at ——, 42 U.S.L.W, at 4804.

The government argues here that Cities' balance sheet reflects a similar substitution. When Cities issued its new debentures and entered them on its balance sheet as debt, it cancelled in its equity account

$58,690,000 representing the stated value of the preferred and $19,661,150 representing a reserve for dividends passed before 1938. The balance of the $115,246,950 face amount of the debentures resulted from a debit to its earned surplus account. The government says that all that occurred was a shift from Cities' equity to its debt account and that no additional cost was incurred in retaining the old capital.

Cities argues, on the other hand, that it did incur additional cost since it became unconditionally liable to repay $115,246,950 for which it originally had received only $45,323,846. Although on the exchange the face amount of the debentures equalled the aggregate call price of the preferred, this amount did not represent a matured obligation of the company prior to the exchange since the exercise of the call option rested in the discretion and good faith of management. The preferred had no legal claim on the earned surplus for the difference before the exchange. They did have such a claim afterwards.

In *National Alfalfa*, the Court emphasized that the fact that a fixed obligation replaced an uncertain one was not alone enough to establish the additional cost required to give rise to deductible bond discount. The critical fact that distinguishes that case from the instant one is that all that occurred there was the substitution of one fixed $50 obligation for another. Moreover, the corporate taxpayer actually had received $50 in cash for the preferred at the time of its issuance. It neither paid nor obligated itself to pay more than the $50 it originally had received. To

allow the corporation a tax deduction for repayment of any part of these funds—funds which it in fact had received—would have resulted in a windfall.

As we read *National Alfalfa*, the original consideration is the *minimum* value to be assigned to the preferred received in exchange for the debentures. —— U.S. at ——, 42 U.S.L.W. at 4800. See *Erie Lackawanna R.R. Co.* v. *United States*, 422 F.2d 425, 430 (Ct. Cl. 1970); *Missouri Pacific R.R. Co.* v. *United States*, 427 F.2d 727, 734 (Ct. Cl.), *modified*, 433 F.2d 1324, 1325-26 (Ct. Cl. 1970), *cert. denied*, 402 U.S. 944 (1971). In short, where the original consideration equals the face amount of the debentures, no discount can arise since their issue price equals their face amount.

In the instant case, there is no such equality. The face amount of Cities' debentures far exceeds both the stated value of the preferred and the original consideration paid in at the time of its issuance. In order to retain the use of the capital represented by its preferred and preference stock, Cities incurred an additional cost [12] through replacement of an uncertain

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[12] In *National Alfalfa*, the Court also held on the facts there presented that no additional capital had been acquired. —— U.S. at ——, 42 U.S.L.W. at 4803. While additional capital might be said to have been acquired here because the market value of the preferred as found by the district court exceeded both its stated value and the original consideration paid for it, clearly no adjustment to the asset side of Cities' balance sheet was made nor could one have been made. Moreover, the Court expressly rejected the relevance of the market value of the preferred in *National Alfalfa* because the taxpayer did not have to go into the market to acquire the stock. While recog-

(or perhaps non-existent) obligation, i.e. the stated value of the preferred, with a fixed one *of greater amount*, i.e., the face amount of the debentures.

To the extent that the district court below allowed a deduction for debt discount resulting from the exchange by Cities of its debentures for its own preferred stock and to the extent that the court specified the original consideration paid in for the preferred as the floor for determining the value of the debentures at the time they were issued, we affirm.[13]

III. Appropriate Measure of Debt Discount

Having held that Cities incurred an additional cost for the use of capital by its exchange of preferred stock for debentures, we turn now to the issue of the appropriate measure of that cost.[14]

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nizing this surface similarity between *National Alfalfa* and the instant case, we hold that it is not a controlling factor in the instant case in view of the Supreme Court's emphasis that the inquiry should focus upon the *additional cost incurred* rather than upon the *additional capital acquired*.

[13] See note 2, *supra*.

[14] This is the issue to which part III of the *National Alfalfa* opinion is addressed. —— U.S. at ——-——, 42 U.S.L.W. at 4802-03. Mr. Justice Stewart concurred in part III (as well as parts I and II), but not in part IV.

Part IV of the *National Alfalfa opinion*, —— U.S. at ——-——, 42 U.S.L.W. at 4803-04, dealt with the issue of whether the corporate taxpayer by the exchange had incurred an additional cost for the use of capital. This is the issue to which the preceding section of our opinion is addressed. Pages 745-751, *supra*.

The Court in *National Alfalfa* stated the economic basis for debt discount:

> "The economics underlying discount is that it is an adjustment of the difference between the interest prescribed in the instrument issued and the prevailing market rate for money, and it arises because the prescribed rate is too low to sell the obligations at par in that market." —— U.S. at ——, 42 U.S.L.W. at 4803.

Where bonds are issued for cash in the open market, the marketplace determines this adjustment. But where the transaction is insulated from the market, as in *National Alfalfa*, there are no market forces to perform the evaluation process.

In *National Alfalfa*, the Court was disturbed chiefly by two related facts: first, the claimed fair market value of $33 per share for the preferred was the product of an extremely thin market and, second, there was no guarantee that this price for the preferred bore any relation to the fair market value of the bonds which had been issued. Since the transaction had been insulated from the market, the taxpayer in effect was asking the Court "to speculate about the market price and value to the corporation of the debentures in question had they been sold upon the open market." —— U.S. at ——, 42 U.S.L.W. at 4802. There was no proof that the discount claimed by the taxpayer had been fixed by anything other than an arbitrary determination by the corporate directors:

> "[T]here is no evidence of what the fair market value of the bonds was at the time of their issuance. Other factors that would have to be considered would include [the taxpayer's] financial condition at the time of the exchange, including both its credit position and its profits prospects, and the availability and cost of capital in the general market as well as from its preferred shareholders. Normally, the market itself performs this evaluative process. Aside from the fact that the transaction was insulated from the market processes, there has been no attempt here to show that the discount rate was determined with a view toward accounting for these several factors rather than simply having been predicated on the par value of the preferred." —— U.S. at ——, 42 U.S.L.W. at 4803.

In the instant case, Cities argues that its exchange was quite different from that in *National Alfalfa*. Here the exchange was not insulated from the market since the preferred shares were widely held and actively traded on the Boston Stock Exchange and the New York Curb Exchange. Moreover, the instant exchange took place only after hearings and scrutiny by the SEC and after bargaining with the preferred shareholders. Cities points out that the aggregate fair market value of the preferred at the time of the exchange, $86,313,600—as arrived at by its expert and accepted by the court below, 362 F.Supp. at 835-38 (Tenney, *J.*)—is the product of an evaluation of those factors outlined by the Court in *National Alfalfa*. —— U.S. at ——, 42 U.S.L.W. at 4803.

Assuming this to be so, the critical deficiency in the record before us is the absence of any finding as to the market value *of the debentures* at the time of their issuance. This is indispensable to measuring the debt discount. The sole issue determined on the third round in the district court below was the value to Cities of the preferred and preference stock received on the exchange. 362 F.Supp. at 835-38 (Tenney, *J.*). This was the sole issue ordered for trial on the first round in the district court. 316 F.Supp. at 74 (Mansfield, *J.*). Since *National Alfalfa* was decided by the Supreme Court subsequent to the district court decisions below, we have the benefit of hindsight in holding that the appropriate question for the district court to answer, in order to measure debt discount, is what was the market value of the debentures at the time of the exchange, rather than the value to Cities of the preferred it received.

In *National Alfalfa*, the Court made clear that the relevant inquiry in determining bond discount is the market value of the debentures when issued. True, an equivalence in value of the debentures and preferred shares might be assumed if the debentures were issued for cash and/or property in the marketplace. But it should be noted that the opinion in *National Alfalfa* dealt separately with the fair market value of the preferred and the fair market value of the debentures involved in that exchange. —— U.S. at ——, 42 U.S.L.W. at 4802-03. Any assumption of an equivalence of the debentures and the preferred is unjustified where the transaction is insu-

lated from the marketplace since the market forces which normally would bring about an equivalence of the two are absent. Here there is no proof that the two were equal. The Court's observation in *National Alfalfa* is applicable here: "[T]here has been no demonstration that the difference between the [fair market value of the preferred] . . . and the face amount of the debentures is attributable to debt discount." —— U.S. at ——, 42 U.S.L.W. at 4803.

The amount of debt discount must be determined by reference to a market evaluation and not a private transaction. The issue for determination by the district court here is that indicated by the Court in *National Alfalfa*:

> "[T]he market price and value to the corporation of the debentures in question had they been sold upon the open market." —— U.S. at ——, 42 U.S.L.W. at 4802.

Accordingly, we reverse and remand to the district court for determination of this issue.[15]

For the guidance of the district court, we wish briefly to comment on certain evidence in the instant record relevant to the issue to be determined on remand. Unlike the situation in *National Alfalfa*, the

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[15] Since the market value of the debentures at the time of the exchange is the issue to be determined, rather than the value received by Cities on the exchange, we also reject Cities' contention that the original consideration paid in upon issuance of the preferred, $45,323,846, is the figure to be used in determining debt discount. Original consideration is a minimum, not a maximum.

issue to be determined here is not a matter of speculation.[16] Here both the preferred and debentures were being traded at the time of the exchange. On May 27, 1947, the day prior to the exchange, the aggregate closing market price of the preferred was $104,827,450. Contrary to the implication of the district court that this market price is irrelevant because it was dependent on the value of the consideration to be received in exchange for the stock, 362 F.Supp. at 837, we suggest that for this very reason it is relevant to the determination of the market value of the debentures at issuance. The closing price of the debentures on the date of their issuance was 91⅞,[17] or an aggregate market price of $105,883,135. We suggest that both of these figures may be relevant to the determination of the market value of the debentures at the time of their issuance. Which of these two measures (or what combination of them) is more appropriate presumably will depend in part on which market was less thin. That determination, among others, is for the district court.

On this appeal it is not for us simply to choose one or the other. Rather, it is for the district court to determine what is the best available market assess-

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[16] Indeed, if it were a matter of speculation only, *National Alfalfa* would require us to reverse and remand with instructions to dismiss.

[17] This figure, apparently through a printer's error, is stated to be "71 7/8" in the published district court opinion. 316 F. Supp. at 66. The figure appears correctly as "91 7/8" in the original filed opinion.

ment of the value of the debentures at issuance. As indicated in *National Alfalfa*, where there is no available market evaluation, the district court's inquiry might include consideration of the taxpayer's "financial condition at the time of the exchange, including both its credit position and its profits prospects, and the availability and cost of capital in the general market as well as from its preferred shareholders." —— U.S. at ——, 42 U.S.L.W. at 4803. No such inquiry would appear to be required here since a market assessment of these factors is available.[18]

IV. Amortization of Debt Discount

Finally, we turn to the propriety of the district court's exclusion, in computing the deduction to be allowed to Cities for the years 1953 and 1954, of amortization of debt discount attributable to the pre-1953 years. Cities did not claim on its tax returns for the years prior to 1953 a deduction for amortization of discount resulting from the issuance of the debentures in 1947. For the reasons below, we af-

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[18] Such an inquiry, however, might be required if the district court determined that both markets were too thin to provide a market evaluation of the debentures. Of course, the facts underlying such a determination must be such that the district court's decision is not the sheer speculation that *National Alfalfa* condemned. See note 16, *supra*. While we recognize that the line dividing speculation from the proper evaluation of market value in the absence of a market evaluation may on occasions be unclear, we leave its development to future cases.

firm the district court's exclusion of such amortization of debt discount for the pre-1953 years.

The issue presented is essentially one of accrual accounting. It involves the interplay of Section 163 (a) of the Internal Revenue Code of 1954 [19] on the one hand and Sections 446 and 461 of the 1954 Code [20] on the other.

Section 163(a) provides:

> "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

The Treasury Regulations currently in effect, Treas. Reg. § 1.163-3 (1968),[21] dealing with the tax treat-

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[19] Int. Rev. Code of 1954, § 163(a), 26 U.S.C. § 163(a) (1970) [formerly Int. Rev. Code of 1939, § 23(b), 26 U.S.C. § 23(b) (1952)]. See note 2, *supra*.

[20] Int. Rev. Code 1954, §§ 446, 461(a), 26 U.S.C. §§ 446, 461(a) (1970) [formerly Int. Rev. Code of 1939, §§ 41, 43, 26 U.S.C. §§ 41, 43 (1952), respectively].

[21] Treasury Regulation § 1.163-3 (1968) provides in pertinent part:

> "§ 1.163-3 Deduction for discount on bonds issued on or before May 27, 1969
>
> (a) Discount upon issuance. (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. . . .
>
> * * * *
>
> (3) Deduction upon repurchase. (1) . . . if bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of discount deducted prior to repurchase, . . . the excess of the purchase price over the

ment of debt discount are substantially similar to those in effect in the tax years in question. See *Chock Full O' Nuts Corp.* v. *United States, supra,* 453 F.2d

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issue price adjusted for amortized . . . discount is a deductible expense for the taxable year."

Treasury Regulation § 1.163-3 first appeared in substantially this form in 1968. T.D. 6984, 33 Fed. Reg. 19175 (Dec. 24, 1968). Prior thereto, debt discount was dealt with in Treasury Regulation § 1.61-12(c)(3), 26 C.F.R. § 1.61-12(c)(3) (1958) rev.), adopted in 1957. T.D. 6272, 22 Fed. Reg. 9424 (Nov. 26, 1957).

Tax treatment of debt discount under the Internal Revenue Code of 1939 was provided for in § 39.22(a)-17 of Regulations 118, 26 C.F.R. § 39.22(a)-17 (1953 rev.), replacing § 29.22(a)-17 of Regulations 111, 26 C.F.R. § 29.22(a)-17 (1949 ed.). This was the pertinent regulation in effect for 1953; it also applied to 1954 by virtue of Internal Revenue Code of 1954, § 7807(a), 26 U.S.C. § 7807(a) (1970) and Treasury Regulation § 1.0-1(b) (1954), which provided for the continuance in effect of certain regulations under the Internal Revenue Code of 1939 until superseded by new regulations under the Internal Revenue Code of 1954.

Treasury Regulations 118, § 39.22(a)-17(c), provided in pertinent part:

> "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year."

See generally *Commissioner* v. *National Alfalfa Dehydratin & Milling Co., supra,* —— U.S. at ——, 42 U.S.L.W. at 4800 and n.7; *Montana Power Co.* v. *United States,* 232 F.2d 541, 546-48 (3 Cir.), *cert. denied,* 352 U.S. 843 (1956).

at 302. The regulations provide not only for annual amortization of debt discount, but also for an adjustment in the year of retirement by repurchase in order to close out the artificial accounting charge allowed for debt discount amortization.

The district court here computed the deductible amounts for 1953 and 1954 by combining the annual amortization of debt discount attributable to debentures outstanding at the end of each year plus the difference between the repurchase price of the debentures retired each year and their issue price (based on its finding as to the value of the preferred to Cities). The court excluded discount on the retired debentures attributable to years prior to 1953 but not claimed by Cities in those years.

Cities argues that this was error. It contends the regulations provide that in the year of repurchase a deduction is to be allowed for the difference between the repurchase price and the issue price, less any amount actually deducted in prior years. If no deduction was taken, so the argument goes, this amount should be included in the adjustment allowed in the year of repurchase. Cities' claim in short is that debt discount may be amortized and deducted over the life of the debentures or it may be recovered in the year of premature retirement through repurchase (or, as a logical extension of this, even at maturity).

While Treasury Regulation § 1.163-3 arguably is susceptible of the interpretation urged by Cities, we reject it as contrary to the intent of the statute. Sec-

tion 446 provides that the method of accounting used in computing taxable income shall be that under which the taxpayer keeps his books unless that method "does not clearly reflect income." Section 461(a) provides in pertinent part:

> "The amount of any deduction . . . allowed . . . shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."

Under these two sections, "the object to be attained is the clear reflection of income for the taxable period. . . ." *Planet Line Inc.* v. *Commissioner*, 89 F.2d 16, 17 (2 Cir. 1937); see *Lucas* v. *North Texas Lumber Co.*, 281 U.S. 11, 14 (1930).

At all times here relevant Cities kept its books and filed its federal income tax returns on an accrual basis. With respect to stated interest accruing on indebtedness over a term of years but payable only at maturity, a taxpayer on an accrual basis may not deduct the full amount in the year of payment but must claim annual deductions of the interest as it accrues. *Planet Line, Inc.* v. *Commissioner, supra; Miller & Vidor Lumber Co.* v. *Commissioner*, 39 F.2d 890 (5 Cir.), *cert. denied*, 282 U.S. 864 (1930); 2 Mertens, The Law Of Federal Income Taxation § 12.95, at 351 (Zimet & Barton rev. 1967); cf. *United States* v. *Anderson*, 269 U.S. 422 (1926). The Supreme Court has recognized the economic resemblance between discount and stated interest. *Commissioner* v. *National Alfalfa Dehydrating & Milling*

Co., supra, —— U.S. at ——, 42 U.S.L.W. at 4802; *United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57, 66 (1965). We see no reason to treat discount differently from interest. To allow a deduction for the entire amount of the discount in the year of retirement would not "clearly reflect" the taxpayer's true income. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282, 288 (1934); *Planet Line, Inc.* v. *Commissioner, supra,* 89 F.2d at 17. In short, a taxpayer that uses the accrual method of accounting must amortize debt discount and take deductions annually over the life of the indebtedness.

Here Cities failed to deduct the amortizable discount for the years prior to 1953 in its returns for those years. We hold that it may not take advantage of that failure in its returns for 1953 and 1954.[22] The deduction for debt discount must be taken in the years to which it is attributable—as Judge Wisdom aptly put it, "not in the year when the taxpayer decides that it is convenient or good business" to accrue the discount. *Guardian Investment Corp.* v. *Phinney*, 253 F.2d 326, 330 (5 Cir. 1958).

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[22] Treas. Reg. § 1.461-1(a)(3)(i) (1957), formerly Regulations 118 § 39.43-2, under the Internal Revenue Code of 1939. Cities' remedy was to file a claim within the applicable period of limitation, see Int. Rev. Code of 1954, §§ 6511, 6532, 26 U.S.C. §§ 6511, 6532 (1970), for credit or refund of any overpayment of tax for those years, rather than for 1953 and 1954. Treas. Reg. § 1.461-1(a)(3)(i) (1967). See also Int. Rev. Code of 1954, § 7422, 26 U.S.C. § 7422 (1970).

We affirm the district court's exclusion of amortization of debt discount attributable to the pre-1953 years.

SUMMARY

The following is a summary of our essential holdings:

(1) Cities' exchange of its debentures for its outstanding preferred stock resulted in a deductible debt discount.
(2) The appropriate measure of that debt discount is the market value of the debentures at the time of their issuance, not the value of the preferred to Cities at the time of the exchange.
(3) Cities is not entitled to a deduction for 1953 and 1954 of amortization of debt discount attributable to the pre-1953 years, since it did not claim such a deduction in its pre-1953 returns.

Affirmed in part; reversed and remanded in part.

SMITH, *Circuit Judge* (dissenting):

I dissent. My brother Timbers' analysis for the majority is quite impressive, yet it seems to me to run counter to the essential thrust of *National Alfalfa*, particularly part IV thereof, considered in the light of the Public Utility Holding Company Act of 1935, pursuant to which the transaction here under review was structured. That Act was thought necessary to simplify the corporate structures of the companies involved, so that investors, rate-makers and

consumers could determine with some hope of accuracy the underlying values involved.[1] It recognized that market values of securities throughout the corporate pyramids were even for those days unusually unreliable.[2] The restructuring was an attempt, under court supervision, to simplify structures in a manner as fair as could be to and between the various classes of security holders. There was here in the restructuring of Cities Service no raising of new capital but merely reshuffling of the old. The "costs" to the corporation do not have sufficient reality to base a tax credit effect, even if we could with confidence agree on comparative "values" of different classes of securities substituted under the plan.

I would reverse for dismissal of the action.

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[1] *See* Conference Report and Statement of the Manager on the part of the House on the Public Utility Holding Company bill (S. 2796), 79 Cong. Rec. 14600ff (1935).

[2] *See* the Act, Title I § 1(b)(1): "when such securities are issued on the basis of fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacities of the properties. . . ."

APPENDIX C

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of December one thousand nine hundred and seventy-four.

Present: HON. IRVING R. KAUFMAN
Chief Judge
HON. J. JOSEPH SMITH
HON. WILLIAM H. TIMBERS
Circuit Judges,

74-1221, 74-1490

CITIES SERVICE CO.,
PLAINTIFF-APPELLEE-APPELLANT

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

Appeal from the United States District Court for the Southern District of New York

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in

part and reversed in part and that the actions be and they hereby are remanded to said District Court for further proceedings in accordance with the opinion of this court.

A. DANIEL FUSARO
Clerk

by VINCENT A. CARLIN
Chief Deputy Clerk

A true copy,

A. DANIEL FUSARO
Clerk

by /s/ Vincent A. Carlin
Chief Deputy Clerk

APPENDIX D

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the fourth day of February, one thousand nine hundred and seventy-five.

Docket No. 74-1221

CITIES SERVICE COMPANY,
PLAINTIFF-APPELLEE-APPELLANT

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellant (United States of America), and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

/s/ Frank R. Kaufman
Judge

A true copy,

/s/ A. Daniel Fusaro
Clerk

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the fourth day of February, one thousand nine hundred and seventy-five.

Present: HON. IRVING R. KAUFMAN,
Chief Judge,
HON. J. JOSEPH SMITH
HON. WILLIAM H. TIMBERS,
Circuit Judges.

Docket No. 74-1221

CITIES SERVICE CO.,
PLAINTIFF-APPELLEE-APPELLANT

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

A petition for a rehearing having been filed herein by counsel for the appellant (United States of America),

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

/s/ A. Daniel Fusaro
Clerk

A true copy,

/s/ A. Daniel Fusaro
Clerk

APPENDIX E

Public Utility Holding Company Act of 1935, 49 Stat. 803 *et seq.*:

Sec. 11.

* * * * *

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out

the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

* * * * *

(15 U.S.C. 79k)

Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)):

Sec. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * *

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 163. INTEREST.

(a) GENERAL RULE.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * *

Sec. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

* * * * *

(b) DEFINITIONS.—

(1) ORIGINAL ISSUE DISCOUNT.—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

(2) ISSUE PRICE.—In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "issue price" means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond increased by the amount, if any, of tax paid under section 4911 (and not credited, refunded, or reimbursed) on the acquisition of such bond or evidence of indebtedness by the first buyer. For purposes of this paragraph, the terms "initial offering price"

and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof.

* * * * *

Treasury Regulations 111 (1939 Code):

Sec. 29.22(a)-17. SALE AND PURCHASE BY CORPORATION OF ITS BONDS.—(1)(*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

(2)(*a*) If, subsequent to February 28, 1913, bonds are issued by a corporation at a premium, the net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases any of such bonds at a price less than the issuing price minus any

amount of premium already returned as income, the excess of the issuing price, minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income), over the purchase price is gain or income for the taxable year.

(3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purphase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. (*c*) If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is gain or income for the taxable year.

(4) (*a*) If bonds were issued by a corporation prior to March 1, 1913, at a premium, the net amount of such premium was gain or income for the year in which the bonds were issued and should not be prorated or amortized over the life of the bonds. (*b*) If the corporation purchases any of such bonds at a price in excess of the face value of the bonds, the excess of the purchase price over the face value is a deductible expense for the taxable year. (*c*) If, however, the cor-

poration purchases any of such bonds at a price less than the face value, the excess of the face value over the purchase price is gain or income for the taxable year.

For exclusion from gross income of income attributable to discharge of indebtedness of certain corporations, see section 29.22(b)(9)—1. For exclusion from gross income of income attributable to discharge of indebtedness of railroad corporations in certain judicial proceedings, see section 29.22(b)(10)-1.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

Sec. 1.61-12 [as republished in T.D. 6500, 25 Fed. Reg. 11402, 11442-11443] INCOME FROM DISCHARGE OF INDEBTEDNESS.

* * * * *

(c) *Sale and purchase by corporation of its bonds.*

* * * * *

(3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already de-

ducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is income for the taxable year.

* * * * *

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